

***United States Court of Appeals
for the Second Circuit***



**BRIEF FOR
APPELLANT**

ORIGINAL

77-7013

UNITED STATES COURT OF APPEALS

for the
SECOND CIRCUIT

B
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BROWNING DEBENTURE HOLDERS' COMMITTEE...;
SIMMS C. BROWNING...; and
ROY E. BREWER...;

Plaintiffs,

ROY E. BREWER and
SIMMS C. BROWNING,

Plaintiffs-Appellants,

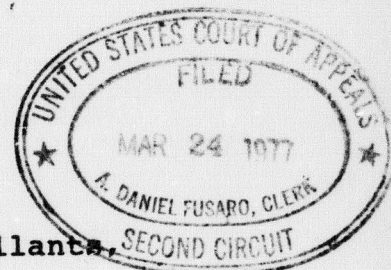
BRADLEY R. BREWER,

Appellant,

-against-

DASA CORPORATION,
ARTHUR ANDERSEN & CO.,
THE BANK OF NEW YORK, et al.

Defendants-Appellees.



ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR
THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF APPELLANTS
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BRADLEY R. BREWER

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Dated: March 22, 1977



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Jacobs, <u>The Impact of Rule 10b-5</u> (rev. 1976), §3.02[e]	5
1 <u>Loss, Securities Regulation</u> , Ch. 3A, 512-514 . . .	59, 60
<u>Montgomery's Auditing</u> (1957) 296-297, 478-479.	56
1 <u>Moore's Manual of Fed. Practice and Procedure</u> §§10.04[2], 9.09[9]	.62, 63
3 <u>Moore, Federal Practice</u> (1974 ed.) ¶¶13.13; 15.02 [1]; 15.13[2]; 15.14; ¶13.32	88, 90
21 N.Y. Jur., EVIDENCE §391	37
3 <u>Pomeroy's Equity Jurisprudence</u> (5th ed. 1941) §§956, 922, 927, 948	7, 8, 10
4 <u>Pomeroy's Equity Jurisprudence</u> §§1089, 1090	8, 9
<u>Restatement, Contracts</u> (1932) §497	7
4 <u>Wigmore, Evidence</u> (3d ed. 1940) §1192	37
6 <u>Wright & Miller, Federal Practice and Procedure</u> §1471	36, 87, 88

PRELIMINARY STATEMENT

A. Procedural Statement

This is an appeal by two of three appellants from (1) a final judgment (No. 77,183; RD 157*) entered on January 17, 1977, and (2) all prior judgments and orders not previously determined on appeal.** Primary among the orders on appeal are: (a) order filed April 21, 1975, as supplemented (RD 91, 93), dismissing the action as against defendant Arthur Andersen & Co. ("Andersen"); (b) judgment entered May 13, 1975 (missing from original record) dismissing the action as against defendant The Bank of New York (the "bank") on the merits, with prejudice, and with costs; (c) order filed January 12, 1976 (No. 43,701) dismissing Claim 3 against defendant DASA Corp. ("DASA" or "Dasa") with prejudice; deciding that the complaint and every motion and paper filed by the plaintiffs in the action, from its beginning to the date of the order, was "frivolous" and made or filed not for the reasons stated, but in "bad faith" and "vexatiously"; and granting DASA's motion for an award of attorneys' fees on equitable grounds; and (d) order filed January 4, 1977, awarding \$54,000 as attorneys' fees and costs to the defendants as follows:

* "RD" refers to Record Document numbers in the original record. This appeal is being briefed and argued on the original record and without appendix pursuant to order of the Court. "PX" refers to plaintiffs' trial exhibits.

** All judgments and orders involved in this appeal were rendered by Judge Owen, S.D.N.Y., after this action was assigned to him in late January of 1974.

to DASA - \$40,000; to the bank - \$7,000; to Andersen - \$7,000.*

B. Nature of the Action

The plaintiffs are convertible bondholders of defendant DASA CORP. The defendants are DASA, its directors, the Trustee under the indenture covering the bonds, (The Bank of New York), and the accounting firm, (Arthur Andersen & Co.) that prepared and certified the financial statements DASA sent to the bondholders in connection with the proxy solicitation from which this action arose. The pivotal issue in the action and on this appeal is not factual, but purely legal---or more accurately equitable---in nature: Did a fiduciary relationship exist between DASA's management and its bondholders in connection with the proxy solicitation transaction in this case which made it a breach of equitable duty and a constructive fraud for DASA to impose upon the bondholders a grossly inadequate consideration for the rights the bondholders surrendered in the transaction? DASA has never maintained that the consideration given the bondholders was fair, reasonable, or adequate. It has simply argued that, as a matter of

* An 8-page thumbnail sketch of the main decisions below is presented in appellants' brief dated 3-7-77 at 25-33. A succinct outline of the complaint and the status of the action at the time of trial (June 1975) is set forth in RD 113, as the first 9 pages of Plaintiffs' Proposed Findings and Conclusions. Another summary of the action and its major issues is included as part of appellants' Form C filed in connection with this appeal. A description of the procedural history from the point of view of plaintiffs' counsel is set forth in RD 127, aff. of counsel filed 2-19-76, ¶'s 70-90, at pp. 61-72.

law, the corporation and its directors owed no equitable obligations of any kind to the bondholders and were therefor free to offer a grossly inadequate consideration if they wished to do so. The district court accepted that argument and dismissed plaintiffs' crucial "fiduciary duty" claims "as a matter of law". This appeal followed, after a lengthy and complex procedural history described in Annex "1" to this brief.*

Plaintiffs based this action mainly upon fiduciary and related proxy disclosure obligations which they maintained the defendants owed them under two related bodies of law:

- (a) the federal securities laws, and
- (b) state law equity principles.

Among other things, plaintiffs contended that they were owed fiduciary duties under both bodies of law.

1. Legal Background

The general legislative purposes of the securities laws are: (1) to provide investors with information necessary to make informed investment and proxy voting decisions, and (2) to prohibit fraud and deceptive practices in connection with securities transactions. H.R. Rep. No. 85, 73rd Cong., 1st Sess. ("Rep"). Specifically, Congress wished to rectify the abandonment in securities transactions of "fair, honest, and prudent dealing" and to ban deceptive, misleading or fraudulent practices as well as "high-pressure salesmanship", manipulations, swindles, and unconscionable conduct of all

* Pages 1-9 of Plaintiffs' 'Proposed Findings of Fact and Conclusions of Law', filed 7/29/75, as part of Rec. Doc. 113.

kinds directed toward the investing public. In two closely related provisions of the Securities Exchange Act of 1934, Sections 10(b) and 14(a), Congress prohibited the use of manipulative or deceptive behavior in connection with securities transactions and proxy solicitations and authorized the SEC to issue "rules and regulations" that would have the force of law defining such behavior. Pursuant to that authority, the Commission issued Rule 10b-5 and Rule 14a-9.* In interpreting those statutes and rules, the courts must bear in mind the specific, stated intention of Congress to enforce "those standards of fair, honest, and prudent dealing that should be basic to the encouragement of investment in any enterprise" and to require "that the persons, whether they be directors, experts, or, underwriters, who sponsor the investment of other people's money, should be held to the highest standards of trusteeship". (Rep., supra, pp. 2, 3.) (Emphasis added.)

The Supreme Court has stated, with specific reference to Section 14(a) and Rule 14a-9, that the purpose of those provisions "is not merely to ensure by judicial means that the transaction, when judged by its real terms, is fair and otherwise adequate but to ensure disclosure by corporate management in order to enable the shareholders to make an informed choice". TSC Industries, Inc. v. Northway, Inc., ____ U.S. ____ (6/14/76, Docket No. 74-1471), Slip. Op. at 9. In a recent decision by this Court under 10(b), Judge Mansfield noted the existence under that statute of a fiduciary duty on

* Part of Regulation 14A, the so-called "Proxy Rules",

the part of corporate management "to deal fairly with the public investors". Green v. Santa Fe Industries, Inc., ____ F.2d ____ (2d Cir. 2/18/76), CCH Fed. Sec. L. Rep. ¶ 95, 447.

Although Sections 10(b) and 14(a) deal with different kinds of securities transactions (one with purchases and sales and the other with proxy solicitation), it is well-established that basic legal concepts such as "materiality," fraud, and deception are interchangeable between the two statutes, despite differences in statutory language, so that a fraudulent practice in violation of § 10(b) would violate § 14(a) if practiced in the appropriate context.* Crane Co. v. Westinghouse Air Brake Co., 419 F.2d 787, 799 (2d Cir. 1969), cert. denied, 400 U.S. 822 (1970); Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 96 (E.D.N.Y. 1969), aff'd., 478 F.2d 1281 (2d Cir. 1973); Walpert v. Bart, 280 F. Supp. 1006, 1016 (D.M.D. 1967), aff'd per curiam, 390 F.2d 877 (4th Cir. 1968); Jacobs, The Impact of Rule 10b-5 (rev. 1976), § 3.02[e], at 1-65.

It is also well-established that in actions under the securities laws the federal courts exercise the jurisdiction of equity and apply equitable principles to the problems presented. Section 27 of the 1934 Act expressly authorizes "suits in equity" under that statute. SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301, 1307 (2d Cir. 1971); SEC v. S & P National Corp., 360 F.2d 741, 750 (2d Cir. 1966); SEC v. American Institute Counselors, Inc., CCH Fed. Sec. L. Rep. ¶ 95,

* The converse is not true in all cases because, among other things, scienter or intent to defraud is not required by § 14(a). See Point I below.

388 (D.D.C., 1975, Gesell, J.); Green v. Santa Fe Industries, supra; Marshall v. AFW Fabric Corp., _____ F.2d _____ (2d Cir. 2/13/76), CCH Fed. Sec. L. Rep. par.95, 448; SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963) ("Fraud ...in the sense of a court of equity properly includes all acts, omissions and concealments which involve a breach of legal or equitable duty". Emphasis supplied. Citing, Moore v. Crawford. 130 U.S. 122, 128 (1888).).

"It is a distinguishing feature of equity jurisprudence that it will apply settled rules to unusual conditions and mold its decrees so as to do equity between the parties". 27 Am. Jur., EQUITY §1 at 518; §12.

In Marshall and Green, supra, the Second Circuit implicitly overruled its prior holding to the contrary in Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972), and held, in substance, that the concept of "constructive fraud", long an established part of equity jurisprudence, is applicable in actions under the securities laws to provide a remedy for unconscionable conduct on the part of controlling security holders who impose grossly unfair or inadequate terms in a transaction governed by those federal statutes.* Constructive fraud is a concept of equity applicable to an act, omission or transaction, which is held by the court to constitute a fraud because it is detrimental to the public interest, contrary to statutory policy, or unconscionable on other grounds, even though the act does not constitute a common law fraud in the

* In so holding, this Court applied principles of federal "common law" in a manner long recognized in federal jurisprudence. See, Deitrick v. Greaney, 309 U.S. 190, 201 (1940); D'Oench, Duhme & Co. v. Federal Deposit Ins. Corp., 315 U.S. 447 (1942).

technical sense and is not done or omitted with specific intent to commit a fraud or to inflict an injury. Bank v. Board of Education, 305 N.Y. 119, 123 (1953); 37 Am. Jur. 2d, FRAUD and DECEIT §4 at 23; 3 Pomeroy's Equity Jurisprudence (5th ed. 1941) §922 ("Untruth is not the distinguishing element of constructive fraud", at 626. "Constructive fraud is simply a term applied to...transactions...which equity regards as wrongful...." at 626). One well-recognized application of the doctrine of constructive fraud involves transactions in which one party, particularly one in a position of confidence or dominant power, provides the other with a grossly inadequate consideration. 3 Pomeroy, supra, §927 at 634, 637. The disproportion between the value of the subject matter and the price may be so great as to warrant the court inferring the fact of fraud. Such a gross inadequacy...will call for explanation, and will shift the burden of proof upon the party seeking to enforce the contract..."); §948 at 763 ("Whenever one person is in the power of another, so that the free exercise of his judgment and will would be impossible, or even difficult, and whenever a person is in pecuniary necessity and distress, so that he would be likely to make any undue sacrifice, and advantage is taken of such condition to obtain from him a...contract which is unfair, made upon inadequate consideration, and the like, even though there be no actual duress or threats, equity may relieve, defensively or affirmatively.); Restatement, Contracts §497; 37 Am. Jur. 2d, FRAUD and DECEIT §440 ("Unfairness of a transaction or the inadequacy of consideration is in itself a factor from which fraud can be inferred, and such inference will operate along

with other evidence to support a finding of fraud. Gross inadequacy of consideration has been declared to be a badge of fraud." at 601). See Green, supra, in which the Second Circuit cited Schoenbaum v. Firstbrook, 405 F.2d 215 (2d Cir. 1968) (en banc), cert. denied, 395 U.S. 906 (1969), as basing liability upon (a) the holding of Pepper v. Litton, 308 U.S. 295, 306-307 (1939) "that directors are fiduciaries" and, (b) the fact that "Banff sold its shares to Aquitaine at an inordinately low price after the directors had learned of the important oil discovery". The breach of fiduciary duty in Schoenbaum was aggravated by self-dealing on the part of directors in control of the terms of the corporate transaction in that case.

Where a situation exists in which one party necessarily places confidence in the other and reasonably expects to be treated fairly by that person, the one in whom such confidence or responsibility is placed, is regarded in equity as a fiduciary. 3 Pomeroy, supra, §956 at 792; 37 Am. Jur. 2d, FRAUD and DECEIT §15 at 38-39; §16. (The equity term "fiduciary or confidential relation" is very broad and "extends to all relations in which confidence is reposed, and in which dominion and influence resulting from such confidence may be exercised by one person over another".); Fisher v. Bishop, 108 N.Y. 25, 28-29 (1888). Corporate directors have long been held to be fiduciaries in dealings between themselves and the corporation and between the corporation and its security holders. Pepper v. Litton, supra; 4 Pomeroy, supra, §1089 ("The equitable rights, duties and remedies are mainly

referable to the trust element of the directors' functions". at 265. "T/he equitable obligations...upon...guardians... corporation directors...executors and administrators are analogous to those resting upon...actual trustees; they result directly from the theory of trusts." at 263-64).

The status of a corporate director as fiduciary and constructive or quasi trustee vis-a-vis the security holders who have invested in the corporation exists by virtue of the fact that the value of the securities held and the rights connected with those securities are affected by the conduct and decisions of the directors. 4 Pomeroy § 1090 at 266. As the facts of the present case clearly illustrate, the decisions of corporate directors can directly affect the value of convertible bonds just as effectively as they can alter the value of shares of stock. Moreover, the definition of "security" provided in § 3(a)(10) of the Exchange Act, clearly includes convertible bonds as well as stock, thus bringing the holders of such bonds under the protection of the statute, including the equity principles of fiduciary duty and constructive fraud incorporated in Sections 10(b), 14(a) and 27.

Where a fiduciary relation is found to exist and the fiduciary has benefitted personally from a transaction with his cestui (as the director-stockholders in the present case did from the terms of the transaction between the corporation and the bondholders), equity imposes the burden of proof upon the fiduciary "to show that the transaction is just and fair, and that he has derived no unfair advantage

from his fiduciary relation." Fisher v. Bishop, 108 N.Y. 25, 29 (1888); 3 Pomeroy, supra, 956; Pepper v. Litton, supra, 308 U.S. at 306, 307; 37 Am. Jur. 2d, FRAUD and DECEIT § 441 ("If the superior party obtains a possible benefit, equity raises a presumption against the validity of the transaction...and casts upon such party the burden of proving the fairness, honesty, and integrity in the transaction...").

Inadequacy of consideration may of itself be a sufficient basis for a finding of constructive fraud in equity. Ballentyne v. Smith, 205 U.S. 285 (1907), (Foreclosure sale set aside because price paid was one-seventh the value of the property.) Where there is not only a grossly inadequate consideration, but also a pre-existing fiduciary relation and self-dealing by the fiduciary directors, the existence of an equitable fraud is clear-cut.

2. Summary of Claims 3 and 4

In early 1972 DASA Corp. was in severe financial difficulty. Contrary to false statements in its annual reports, its financial condition had steadily deteriorated over a period of time. It was suffering a severe but undisclosed cash flow crisis so drastic that interest payments on its \$6 million in outstanding convertible debentures were not made when due on January 1, 1972, but had to be delayed for about a week while management scraped together the necessary cash. Sales of assets over a period of time to cover operating losses had so reduced corporate assets that the corporation was

insolvent on its balance sheet, but that insolvency was papered-over by the inclusion on the balance sheet* of an intangible asset valued at \$1.5 million which the corporate auditor (defendant Andersen) refused to certify as genuine at the stated value.** Despite Andersen's refusal to certify that asset, DASA's management insisted that it remain on the balance sheet. The dispute, the nonexistence of the asset, and the consequent balance sheet insolvency were all disguised in a footnote to the balance sheet that plaintiffs maintain was materially misleading. None of the proxy disclosure issues indicated by the above facts was dealt with by the district court in its post-trial opinion.

Two senior creditor banks had apparently allowed several million dollars of credit to be extended to DASA without focusing too closely on its steadily deteriorating financial picture. They decided in 1971 that they wished the amount of their outstanding balances to be paid off in full and promptly, undoubtedly with the four-month Bankruptcy Act provision in mind. The means fixed-upon by DASA's management to pay off the banks was sale of the company's last, remaining, salable assets: an inventory of fully-leased IBM 360 computers that represented approximately 20 percent of corporate assets and contributed a positive cash flow. In effect, the

* PX 3 (1970 Annual Report); PX 4 (March 9 solicitation letter ["M-9"]; PX 32 (1971 Annual Report). See brief of 3-7-77, pp. 58-67 for an explanation of the \$1.5 million "phantom asset" included as an intangible item on DASA's 1971 balance sheet to conceal corporate insolvency in the balance sheet sense.

** See PX 47, letter from SEC to DASA stating this fact.

corporation had been in the process of unannounced, piecemeal liquidation for a substantial period of time. But the proposed sale of these assets represented a quantum leap.

A provision in the convertible debenture trust indenture* prohibited sale of the computer assets without the written consent of two-thirds of the bondholders. There were no physical assets allocable to corporate equity in the event of bankruptcy and liquidation. Only by inclusion on the balance sheet of an intangible asset valued arbitrarily at \$1.5 million (and attacked as fraudulent by the plaintiffs) was DASA able to show even a nominal equity for the common stockholders. Both realistically and according to generally accepted accounting principles, DASA had no stockholders' equity. Its stock was "under water" by more than \$1.0 million. In the event of liquidation, the banks would have been paid in full, the bondholders would have received a fraction of the face value of their bonds, and the common stockholders would have received nothing. *PX-1

DASA's directors were, of course, elected by the common stockholders, not the bondholders. The five controlling directors owned common stock with a market value of more than \$11.0 million and no significant amount of bonds. Thus the personal interests of the directors corresponded to those of the stockholders with regard to the conflict of interests that arose in connection with the solicitation of proxy "consents" from the bondholders.

To obtain the necessary proxy "consents" from the holders of two-thirds of the bonds, DASA sent a consent solici-

tation letter to the bondholders on March 9, 1972, (the "Mar-
ch 9 letter" or "M-9")*and in that letter offered the bond-
holders, as a consideration in exchange for the solicited
consents, a reduction in the conversion price of the bonds
from \$42.42 to \$21.00. Plaintiff Browning is a Chartered
Financial Analyst.** As such, he is an expert in corporate
finance and securities analysis. He had purchased the bonds
some years before as the obligations of a corporation (CTI)
merged into DASA in 1969. In his expert opinion (and in the
opinion of plaintiffs' trial expert, Professor Bellemore ***
from New York University) the conversion price offer was
completely worthless, unfair to the bondholders, and completely
out of line with reasonable principles of financial analysis
and equity. The market price of the common stock was then
around \$4.50. It is now perhaps 50 cents, and there is no
regular market for it, as there was in 1972.

The lower the conversion price, the more shares of
stock would be allocated to each bond.**** Consequently, the
interests of the DASA stockholders and bondholders conflicted
over how high or low the new conversion price should be. The
\$21.00 price offered by DASA was grossly inadequate by any
standard, and has never been defended by DASA on grounds of
fairness or adequacy. The bondholders had no practical choice
but to accept whatever offer DASA made to them in its proxy
material because the circumstances provided no mechanism for

** RD 130 (T-SCB, i.e., trial testimony of Browning).

*** PX 112, 115; RD 175.

**** See brief of 3-7-77, pp. 76-80 for an explanation of the
arithmetic of conversion price changes.

bargaining on the matter and rejection of the offer would have resulted in blockage of the proposed asset sale. That, in turn, would have been calculated to cause prompt corporate bankruptcy, an unacceptable result for the bondholders as well as the stockholders.

The plaintiff bondholders sued for breach of equitable duties and violation of the proxy rules. In connection with their "fiduciary duty" and "constructive fraud" theories of recovery, they maintained, (A) that DASA's directors owed a fiduciary duty of fair treatment to the convertible bondholders as public investors who had placed \$6 million of their funds in the corporation; (B) that such duty required DASA to offer the bondholders a fair and reasonable new conversion price as consideration for the creditors' rights it was asking them to surrender; (C) that a fair price would be at or near the present market (\$4.50) but they would accept either something between \$6 and \$12 or a figure selected by an independent expert financial analyst; (D) that because such a fiduciary duty existed, because the directors were elected by the stockholders (whose equity would be potentially diluted by the allocation of more shares to the bondholders), and because the five controlling directors owned or controlled common stock worth over \$11 million the value of which would be substantially reduced by the offer of a fair conversion price (a potential immediate loss of \$3.7 million from the \$11 million), a substantial conflict of interest existed for the directors in fixing the proposed new conversion price which disqualified the financially interested directors

from voting on it and required that it be determined in an independent and objective fashion based upon qualified expert opinion.

The DASA directors maintained that their sole fiduciary duty was to the stockholders, that no duty of fairness was owed to the bondholders, that no duty existed to offer a fair conversion price, and that no duty existed under the Proxy Rules to disclose to the solicited bondholders that no attempt was being made to offer them a fair price and that the price offered was in fact grossly unfair and worthless. DASA has never argued that the price offered was fair and reasonable. It has implicitly conceded that, if a duty was owed to the bondholders, that duty was substantially violated in this case. DASA's president admitted to Browning and to his attorney at a DASA Board organizational meeting prior to March 9 that no attempt would be made to offer a fair conversion price. Browning so testified at trial.

Browning, appellant Roy Brewer and attorney Bradley R. Brewer, were all holders of the bonds since 1969 or so. They formed the Browning Committee informally in February of 1972 when the impending solicitation was first disclosed in annual meeting proxy materials. One of its main purposes was to bargain for a fair conversion price. Bradley Brewer joined as a third member because three bondholders are needed under the Trust Indenture Act in order to communicate with other bondholders through the indenture trustee. The Committee was named a plaintiff in the suit to act as a name

entity for communicating with other bondholders in the event of class action certification. It never owned any bonds.

The actual bondholder plaintiffs are Browning and Roy Brewer.

Browning took the position in communications with the indenture trustee bank (defendant-appellant, The Bank of New York) that in his judgment the bondholders were being cheated and defrauded in the M-9 solicitation in violation of fiduciary and disclosure obligations under federal and state law, that as indenture trustee it was obligated as a fiduciary under federal and state law to determine whether or not such wrongs were being inflicted in fact or law, and that any failure on its part to take reasonable steps in the circumstances to protect the interests of its beneficiaries, the bondholders, would be conscious and wilful breaches of trust rather than merely negligent or inadvertent omissions. The bank took the position, that it owed no duty of any kind to the bondholders prior to the occurrence of a default as technically defined in the indenture.*

* In Morris v. Cantor, 390 F. Supp. 817 (S.D.N.Y., 1975, Ward, J.), a case decided after this action was commenced, Judge Ward held that a predefault duty exists on the part of an indenture trustee against doing wilful, but not negligent or inadvertent, injury to the interests of the bondholders. 'Despite citation of that authority to the district court, that court, without acknowledging the existence of the case or its thoughtful reasoning, found plaintiffs' position on its claim against the bank to be "without precedential support," required the posting of a \$25,000.00 undertaking in favor of the bank and dismissed the action with prejudice when (as he had been told) they were unable to post it. See, Kusner v. First Pennsylvania Corp., F.2d (3d Cir. 1976), CCH Fed. Sec. L.Rep. ¶ 95, 475 (bondholders' right to sue "outside the indenture" upheld, reversing dismissal below).

It is not disputed that DASA was in such severe financial difficulty at the time of the proxy solicitation that it would very likely have gone out of business or into bankruptcy if it had not been able to complete the sale of the computers and thereby substantially reduce its debt service. Because of the corporation's financial crisis, the bondholders had no realistic choice but to submit the proxy consents solicited by DASA management and thus approve the proposed transaction. The only alternative available would have been corporate bankruptcy, patently an unacceptable result.* Thus the bondholders were forced by the circumstances created by DASA's management into a situation where they had, realistically speaking, no choice but to accept the conversion price terms offered unilaterally by DASA in the March 9 letter, because they could not reject those terms without also rejecting the computer sale and bankrupting the company.

Given those circumstances, the plaintiffs maintain that a relationship of dominant control and confidence existed between the DASA management and the bondholders with respect to the conversion price terms, that grossly inadequate terms were forced upon them which they were powerless to resist, and that relationship imposed a fiduciary duty upon the DASA directors to offer a fair and reasonable consideration to the bondholders. When the adequacy of the conversion price offered was

*Plaintiffs argue that they should have been allowed to present a third alternative by being permitted to distribute a proxy solicitation in competition with DASA. They say they were precluded from doing so by judicial error in denying their motion for a preliminary injunction and by acts on the part of DASA management in violation of the Proxy Rules 7 and 8.

challenged in this action, the burden of proof to justify the transaction should have been shifted to DASA. The failure of the district court to recognize the fiduciary relationship, to shift the burden of proof, and to admit evidence offered by the plaintiff to prove the gross inadequacy of the terms offered was clearly contrary to controlling principles of equity cited above. For the existence of fiduciary duties to convertible bondholders and application of the doctrine of constructive fraud where action by the directors benefits themselves and affects the value of the bonds, see Harff v. ... :ian, 347 A.2d 133 (Del. 1975). * Marshel, Green and other cases cited above hold that the antifraud provisions of the Exchange Act (10(b) and 14(a)) prohibit controlling corporate directors from offering a grossly inadequate consideration in a transaction governed by those statutes.

Clearly plaintiffs' fiduciary-duty and conflict of interest theories of recovery were the guts of the action, both in its "equity" aspect and in its "nondisclosure" aspect under the Proxy Rules. The district court acknowledged that in its January 12 opinion. Those theories were dismissed on the second day of the five-day trial not for lack of evidence (for the trial was not over) but "as a matter of law," i.e., on a basis similar to the Rule 12(b) ground that the complaint failed in that respect to state a claim upon which

* For a 6 page statement of reasons why Harff is squarely on point with the present case, see appellants' 3-7-77 brief, Pt. II at 140-146. Limits of space preclude its inclusion here,

relief could be granted. The sole authority cited by the court from the bench for that crucial ruling was Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974). On the basis of that ruling all subsequent offers of evidence on the unfairness and impropriety of the \$21.00 conversion price offer, including expert testimony, were deemed irrelevant. The Delaware Chancellor was reversed on the fiduciary duty issue. 347 A.2d 133 (Del. 1975).^{*} Perhaps aware of that fact, but making no reference to it, the district court undertook to justify its rejection of the fiduciary duty theories by citing Abramson v. Nytronics, Inc. 312 F. Supp. 519, 524 (S.D.N.Y., 1970, Mansfield, J.), for the proposition that it was no concern of the federal courts under the Proxy Rules whether or not corporate management dealt unfairly with solicited security holders as long as sufficient relevant facts were disclosed. In that respect, Abramson corresponds to Popkin v. Bishop, 464 F.2d 714 (2d Cir. 1972), the relevant holding of which has been rejected and implicitly overruled recently by two learned panels of this Court in Marshel v. AFW Fabric Corp., ___ F.2d ___ (2d Cir. 2/13/76), CCH Fed. Sec. L. Rep. ¶ 95, 448, and Green v. Santa Fe Industries, Inc., ___ F.2d ___ (2d Cir. 2/18/76).^{**}

^{*} See Rec. Doc. 124, 125

^{**} See Rec. Doc. 128. Plaintiffs criticized Abramson as questionable authority early in this action (RD 26, filed 6-12-72, at 29-31) because in deciding Abramson the court was apparently unaware of the recently decided Mills case. See brief of 3-7-77, pp. 32-33 for an explanation of apparently revised views on Abramson by Judge Mansfield and Judge Motley, cf. Seigel v. Merrick, CCH Fed. Sec. L. Rep. ¶95, 467.

Thus to date three separate appellate courts have rejected the conclusion or conclusions of law applied by the district court to the essentially undisputed facts of this case. No valid authorities were cited by the district court in support of those pivotal rulings. In ruling on the correctness of those substantive rulings below, this court is of course not limited by the "clearly erroneous" rule. In re Joseph Kanner Hat Co., Inc., 482 F.2d 937 (2d Cir. 1973). It is enough for reversal that this Court be convinced that the result reached below does not jibe with the applicable principles of law.

ARGUMENT

POINT I

TAKEN INDIVIDUALLY OR COLLECTIVELY,
DEFECTS OF DISCLOSURE WERE PROVEN
AT THE TRIAL WHICH CONSTITUTED VIOLATIONS
OF SECTION 14(a) AND THE PROXY RULES

1. Applicable Principles of Law

Under Section 14(a)* and Proxy Rule 14a-9** there-
under, it is prima facie unlawful to distribute any
proxy solicitation material covered by the Exchange Act
"containing any statement which ... is false or misleading
with respect to any material fact, or which omits to
state any material fact necessary in order to make the
statements therein not misleading." Mills v. Electric
Auto-Lite Co., 396 U.S. 375, 383 (1970), quoting from
J.I. Case v. Borak, 377 U.S. 426 (1964).

* Section 14(a) provides, in pertinent part, that "it shall
be unlawful for any person ... in contravention of such
rules and regulations as the Commission may prescribe ...
to solicit or to permit the use of his name to solicit any
proxy. ..."

** Proxy Rule 14a-9(a) provides that "no solicitation subject
to this regulation shall be made by means of any proxy
statement... containing any statement which, at the time
and in the light of the circumstances under which it is
made, is false or misleading with respect to any material
fact, or which omits to state any material fact necessary
in order to make statements therein not false or misleading
or necessary to correct any statement in any earlier
communication with respect to the solicitation of a proxy
for the same meeting or subject matter which has become
false or misleading."

Rule 14a-9(b) provides that "the fact that a proxy statement...
has been filed with or examined by the Commission shall not be
deemed a finding...that such material is accurate or complete
(Cont'd on next page)

A major Congressional purpose in passing the federal securities laws was to incorporate into federal law its conviction "that the persons [including corporate directors]...who sponsor the investment of other people's money, should be held to the highest standards of trusteeship." H.R.Rep. No. 85, 73rd Cong., 1st Sess, at 2-3.* Clearly the DASA directors in this action were persons who sponsored the investment of \$6.0 million in the corporate enterprise by the bondholders. The \$6.0 million proceeds of the CTI debenture offer was held in cash by CTI when it merged with DASA in 1969. What plaintiffs sought to have the courts do in this action was simply to hold DASA and its directors to "the highest standards of trusteeship," as Congress intended.

** FD 130

(T-SCB-52-59, 224, 194-96)** The district court refused to do so, holding instead that no fiduciary relation or obligations of any kind existed in this case between the directors and the bondholders. That holding was in error.

According to the Supreme Court, one of the two main purposes of Section 14(a) is "to ensure by judicial means that

* A specific legislative purpose of the Exchange Act and Sections 10(b) and 14(a) thereof was "to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus achieve a high standard of business ethics in the securities industry." Affiliated Ute Citizens v. U.S., 406 U.S. 128, 153-154 (1972). In particular, Section 14(a) originated in a congressional belief that "'fair corporate suffrage is an important right that should attach to every security bought on a public exchange.'" HR Rep. No. 1383, 73d Cong., 2d Sess. 13. The provision was intended to promote 'the free exercise of the voting rights of stockholders' by ensuring that proxies would be solicited with 'explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought.' Id., at 14; S. Rep. No. 792, 73d Cong., 2d Sess., 12; see 377 U.S. at 431." Mills, supra, 396 U.S. at 381, quoting from J.I. Case v. Borak, supra.

** (Cont.) and not false and misleading, or that the Commission has passed upon the merits of or approved any statement contained therein.

the transaction, when judged by its real terms, is fair and otherwise adequate." TSC Industries, supra (Slip Op. at 9). That purpose and judicial duty stems directly from the intent of Congress cited above. The other purpose of §14(a) stated in TSC is "to insure disclosure by corporate management in order to enable the shareholders to make an informed choice." (Id.) Judge Mansfield of this Court has stated that there is a fiduciary duty under the Exchange Act requiring corporate directors "to deal fairly with the public investors." Green, supra. Clearly the bondholders in this action were "public investors" in DASA and holders of a "security" within the meaning of §3(a)(10).

On the facts of this case, DASA and its directors did not "deal fairly" with the bondholders. At no time in the long history of this action did DASA make any attempt to defend the \$21 conversion price as fair or adequate. It offered no proof at trial of the fairness or adequacy of the terms it forced upon bondholders in the crisis circumstances of the March 9 proxy solicitation. But for its error in failing to recognize the relevance and applicability of equity principles to the issues of this case, the district court would have placed the burden upon DASA and its directors to justify by clear and convincing proof the fairness of the treatment afforded to the bondholders and the adequacy of the terms imposed. (T-SCB-54-62) At trial, the district court stated clearly its erroneous belief that considerations of fiduciary duty and its obligations as a court of equity had no bearing whatever on this case: "Mr. Brewer: Courts of equity, your

Honor.... The Court: Let's not get into courts of equity."
(T-SCB-74) See, Rosenfeld v. Black, 445 F.2d 1337, 1343-45
(2d Cir. 1971), cert. dismissed, 409 U.S.802 (1972) (federal
standards of fiduciary responsibility incorporate common law
standards where appropriate); accord, Galfand v. Chestnut
Corp., F.2d (2d Cir. 11-4-76).

The test of "materiality" under §14(a) is whether
the alleged defects of disclosure, considered singly or
collectively, were such that there existed "a substantial
likelihood that a reasonable shareholder would consider...
[them] important in deciding how to vote" (TSC Industries,
supra), or that the defects would "have a significant
propensity to affect the voting process" (Mills, supra,
396 U.S. 375, 384), or that the omitted facts "would have
assumed actual significance in the deliberations of the reason-
able shareholder" (TSC, supra). In other words, the issue
in this connection is whether a reasonable investor, viewing
the omitted or distorted facts individually or collectively,
would have considered them significant or important in
making the investment decision before him.

In deciding questions of "materiality" and whether
or not there was, in a particular case, the kind of "full
and fair" disclosure and effective corporate democracy and
suffrage required by Section 14(a) and the policy behind it,
the federal courts should adopt the practice or policy of
"resolving doubts in favor of those the statute is designed
to protect." Mills, supra, 396 U.S. at 385; Northway, supra,

Par. 95,007 at p. 97,488.*

2. Application of Law to the Present Facts

An explanation is set forth at pages 67-106 of appellant's brief dated 3-7-77 of eleven false statements, material omissions, and deceptive or misleading characterizations in the March 9 letter "with respect to" material facts,

* See SEC v. Parklane Hosiery Co., F. Supp. (S.D.N.Y., 11-9-76, Duffy J.), Index No. 76 Civ. 2024, Op. #43,351, p. 17 ("If the shareholder is only called upon to evaluate the fairness of the ... [offer made to him], then any omission or statement of fact which would affect the offering price must be material under the Northway test."), p. 19: expert testimony is admissible to show the unfairness of an offer made to solicited security holders.

"Use of a solicitation that is materially misleading is itself a violation of law," regardless of whether the relief is sought before or after the vote questioned or the corporate transaction authorized or ratified thereby. Mills, supra, 396 U.S. at 383.

To prevail in a nondisclosure case under either Section 14(a) or Section 10(b), plaintiffs need only establish the materiality of the omitted information. The "obligation to disclose and [the] withholding of a material fact establish the requisite element of causation in fact." Affiliated Ute Citizens v. U.S., 406 U.S. 128, 154 (1972); Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970); Titan Group, Inc. v. Traggen, 513 F.2d 234, 239 (2d Cir. 1975); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 381 (2d Cir. 1974), cert. denied, 43 U.S.L.W. 3614; Shapiro v. Merrill Lynch, F. Supp. (S.D.N.Y., 1975, Tenney, J.) CCH Fed. Sec. L.Rep. Par. 95, 377 (at 98,883).

Sections 10(b) and 14(a) differ in one significant respect. Under 10(b) it is necessary to prove scienter as part of the claim, and liability may not be based upon negligence by the directors or other defendants. Ernst & Ernst v. Hochfelder, U.S., 96 S. Ct. 1375, 47 L.Ed.2d 668 (1976). Under 14(a) scienter need not be proved, and individual liability may be based upon negligence in the performance of fiduciary and disclosure duties. Nat. Home Products, Inc. v. Gray, F.Supp. (D.Del., 1976), Latchum, J.), CCH Fed. Sec. L. Rep. ¶95,752; Gould v. Hawaiian-American S.S. Co., 351 F.Supp. 853, 858-65 (D. Del. 1972); Gerstle v. Gamble-Skogmo, Inc., 398 F.Supp. 66, 97 (E.D.N.Y., 1969, Bartels, J.), aff'd. 478 F.2d 1281 (2d Cir. 1973); Richland v. Crandall, 262 F.Supp. 538, 553, n. 12. (S.D.N.Y., 1967). This difference arises from the different operative language used in the two statutes.

material omissions, and deceptive or misleading characterizations in the March 9 letter "with respect to" material facts and circumstances of which a reasonably intelligent and diligent bondholder would have wished to be informed in connection with his decision whether or not to fill out a "consent" form and send it to Dasa in response to its mail solicitation and telephone follow-up. All were established at trial, mainly in the documentary evidence and briefs.

The financial statements in M-9 falsely and deceptively overstated Dasa's asset position by \$1.5 million.* The fact that Dasa was insolvent on its balance sheet by \$1.4 million according to generally accepted accounting principles as interpreted by its own independent accountants was omitted and artfully concealed. The financial statements falsely represented Dasa as having a positive shareholders' equity when in fact there was no such equity and the debt represented by the bonds was asset impaired.

The fact that Arthur Andersen & Co. had refused to certify the existence and stated value of an intangible asset representing 22% of Dasa's "physical" assets and 19% of its total assets was either omitted entirely or inadequately indicated in a subtly-worded footnote which was misleading and deceptively unclear in the circumstances and fell far short of reasonably clear disclosure of the material facts with respect to the positions actually taken by Anderson & Dasa management.

* See brief dated 3-7-77, pp. 58-67, 87-89.

As a matter of law, the financial statements in M-9 were not "certified" as required by the Proxy Rules, since approximately 20% of corporate assets and, by implication, the balance sheet solvency of the company, were not in fact certified by the accounting firm that issued the opinion letter submitted to the SEC in purported compliance with those rules.

Dasa omitted from its proxy materials (i) the fact that the consideration being offered to the bondholders in exchange for the concession solicited from them was worthless, and (ii) the fact that the \$21 conversion price offer had been purposely biased by Dasa's directors against the interests of the bondholders and in favor of the interests of the stockholders because of (a) the belief of the directors that they owed no duty to the bondholders that required them to offer a fair or reasonable price but did owe an affirmative duty to the stockholders to benefit them as much as possible at the expense of the interests of the bondholders and (b) the fact that in order to offer the bondholders a fair and reasonable conversion price, it would have been necessary for the Dasa directors to impose upon themselves a loss in the market value of securities owned or controlled by them of millions of dollars and as much as \$3.7 million, according to plaintiffs' expert financial witness.*

Dasa omitted relevant facts cited in the preceding paragraph with respect to the state of mind or collective belief of the Dasa directors that they were duty bound

* PX 112, 115; RD 130, 175.

in fixing the \$21 conversion price offer to gain maximum advantage for the stockholders (and themselves personally) and that they were uninhibited in seeking maximum advantage for the stockholders (and themselves personally) by any obligation of fairness to the bondholders.

Dasa omitted disclosure of the existence and significance of a conflict between (a) the personal financial interests of five controlling directors, and (b) the offering of a fair, reasonable or significant consideration to the bondholders in the form of a new conversion price. M-9 failed to disclose two related facts: (i) that five of the six directors who voted for the \$21 conversion price held or represented Dasa stock worth approximately \$11.19 million at the current market price of \$4.50, and (ii) that an offer of significant consideration to the bondholders would have required a reduction in the conversion price of such magnitude that a substantial, negative impact on the market price of the stock would have resulted. For example, an offer of \$4.50 (stated by plaintiffs' expert witness to be the only fair price) would have resulted in a reduction of the market price of the common to \$3.00 and an economic loss estimated at \$3.7 million to the controlling directors.*

Dasa's solicitation misrepresented the purpose and urgency of the proposed computer sale.** The sale was falsely represented in M-9 as a voluntary

* See brief dated 3-7-77, pp. 80-86.

** See brief dated 3-7-77, p. 91.

or optional action decided upon by management "to improve its working capital position" (p.15) and to alleviate a corporate "need for working capital", whereas in fact the transaction was mandatory or imperative to prevent corporate default and insolvency proceedings, as Dasa's counsel admitted before the district court. The real purpose of the transaction was to avoid corporate reorganization proceedings in which Dasa's management would have been likely to lose control of the company and the common stock would have become worthless, costing the controlling directors over \$11.0 million.

The solicitation letter omitted many items of relevant information requested in comment letters received from the SEC.* For example, there was a failure to disclose or explain the dollar amount of tangible assets available to satisfy the bondholders' claims prior to the proposed sale as compared with the amount of such assets available in the event of corporate liquidation at a later date after completion of the sale.

There was a failure to disclose effectively the magnitude of and reasons for the termination of (i) Dasa's business relationship with Western Electric, ** and (ii) its sales efforts in the territories of AT&T.

There was a failure to correct false, misleading, and conflicting statements about the proposed

* See brief dated 3-7-77, pp. 92-94.

** See brief dated 3-7-77, p. 96.

sale and its consequences made in the annual meeting proxy statement, the 1971 annual report, and M-9.*

There was a failure to disclose (i) the passive and "neutral" role played by the debenture trustee bank in the solicitation process;*(ii) the fact that Dasa's withholding from the Browning Committee necessary information concerning the solicitation process had effectively prevented the Committee from soliciting the bondholders to withhold their consents from Dasa and to send proxies instead to the Committee,**(iii) the facts concerning the Committee's efforts to complete such a proxy solicitation, and (iv) the position and proposal of the Committee that the bondholders withhold submission of their consents to Dasa until it had offered them a new conversion price acceptable either (A) to an independent financial expert retained by Dasa, or (B) to the Committee.

There was a failure to disclose the fact that Dasa's directors had rejected a proposal made by the Committee for the benefit of the bondholders that an independent expert be retained to render an opinion as to what would represent a fair and appropriate conversion price offer.

There was a failure to disclose Dasa's cash

* See brief dated 3-7-77, pp. 67-75,

** See Point II below, T-SCB-157-159 (RD 130),

*** See same brief, pp. 98-102,

flow problems (which were acute and made the proposed transaction "imperative"). However, there was disclosure of Dasa's working capital ratio (which was not so alarming).

M-9 omitted the fact that credit on Dasa's existing lines of bank credit was no longer available on 3-9-72, or thereafter, and the banks had demanded payment in full of all outstanding balance from the proceeds of the computer sale.

M-9 failed to give a comprehensible statement of the reasons for the net loss of \$1,398,500 incurred in fiscal 1971 (M-9, p.5).

Each of the foregoing defects of disclosure separately and all of them collectively were material as a matter of law and constituted a violation or violations by Dasa of Section 14(a). In addition to those defects, there were a number of others pointed out by plaintiffs that would have been found to be statutory violations if it had been necessary to discuss them specifically here.*

3. Judge Owen's Mid-Trial Ruling Based Upon Harff v. Kerkorian

Immediately prior to the trial, in their pretrial memoranda and during a brief pretrial conference with Judge Owen over the issues to be tried, counsel for both plaintiffs and Dasa agreed that the issues of the fairness of the \$21 conversion price and the "equity" or "fiduciary duty" theory were issues presented

* See plaintiffs' post-trial memorandum below dated 7-14-75.

for trial on the merits. Plaintiffs' counsel had indicated well in advance of trial its intention to present expert testimony on issues requiring financial expertise (such as fairness of the conversion price offer, fraudulent or improper nature of the balance sheet, etc.). Dasa made no effort to obtain the name of the expert or experts before trial or to depose the expert. Plaintiffs sought to present expert testimony from two witnesses: plaintiff Browning (a professional securities analyst with a graduate degree and special post-graduate school certification as a chartered financial analyst) and Douglas A. Bellemore, Ph.D., a professor at the New York University Graduate School of Business and a teacher of securities analysis to professional analysts and portfolio managers for over 35 years.

Browning was the first witness, and although he was duly qualified as an expert, the court rigidly precluded expert testimony from him on the erroneous ground that the issues were so clear to the court and so free from complexity that no expert testimony was needed.* Plaintiffs' main witness was their last, Bellemore ("DHB") who testified on June 9, the last day of the six-day trial.

On the second day of trial (June 3), the court made a pivotal ruling from the bench. In that ruling, it (a) dismissed from the action as a matter of law plaintiffs' "equity" or "fiduciary duty" claims based upon the alleged complete worthlessness and unfairness of the \$21 conversion

* T-SCB:61, 5-14, 16-18, 34-37, 42-44, 64-65, 67, 72-73, 79-84, 98, 103, 112-115, 118-120, 126, 146-155.

price offer, (b) based that dismissal upon the court's pure conclusion of law that no fiduciary duty of any kind is owed by a corporation or its directors to holders of convertible bonds such as the present plaintiffs, (c) cited as its sole authority for the nonexistence of any such duty on the facts and arguments in this case a Delaware trial court decision, Harff v. Kerkorian, 324 A.2d 215 (Del.Ch., decided 7-23-74)* (which was cited to the court by one of its law clerks immediately prior to the court's ruling and which had not been cited to the court by the attorneys for either side), and (d) announced that, based upon the dismissal of that theory or claim and the court's conclusion that Dasa and its management owed under state equity principles no duty to offer a fair conversion price, there was consequently no duty to disclose to the bondholders any facts concerning the fairness of the \$21 offer and no further evidence would be admitted related to the alleged fraudulent inadequacy of the offer or the alleged failure to disclose such inadequacy.** Thereafter, the court adhered strictly to that announcement in ruling out of the record evidence offered by plaintiffs. In particular, the testimony of Professor Bellemore on the last day of the trial was severely limited, and the substance of the testimony sought to be elicited from him appears in the record only by virtue of an affidavit and written offer of proof submitted to the court under Rule 43(c), F.R.Civ.P. [PX-112 (offer of

* T-SCB-59-62

** Id. 61, 162, 154

*** Rule 43 was in effect during this trial. It was replaced by the Federal Rules of Evidence as of 7-1-75.

proof); PX-115 (ID only) aff. of DHB].

The dismissal ruling based upon Harff had a highly prejudicial effect upon the presentation of plaintiffs' entire case thereafter because the court relied upon it for ruling inadmissible most of the evidence offered on this central aspect of plaintiffs' case against Dasa. Moreover, the nature of the court's exclusionary rulings thereafter made it impossible for plaintiffs' counsel to make an effective record on appeal because the court repeatedly refused plaintiffs' requests, pursuant to Rule 43(c), that in this nonjury case, where the court sustained an objection to a question, it should permit the witness to answer for the record and thus "take and report the evidence in full" as required by Rule 43(c).

Thus, based upon that Delaware trial court decision only, Judge Owen held, early in the trial, that as a matter of law no fiduciary duty was owed by Dasa or its management to the plaintiffs because, as bondholders, they were creditors and not stockholders of the corporation. Thereafter, no testimony was admitted or allowed into the trial record that related in any way to whether or not a worthless and fraudulent conversion price was offered and, if so, whether such worthlessness was concealed or reasonably disclosed.

That dismissal and the subsequent exclusionary rulings constituted a number of different and highly prejudicial errors: (1) a plain error as to the relevant substantive law on the fiduciary duty claim as set forth in the Chancellor's decision in Harff; (2) an error as to controlling

federal substantive law under Section 14(a) (which the court refused to apply to the facts of the case); and (3) a procedural error in violation of Rule 43(c) and principles of evidence under Rule 43(a) governing the admissibility of expert testimony and the inclusion on the record of answers to questions submitted as offers of proof in a case tried to the bench.

4. Manifest Error of Law in Interpreting
and Applying the Chancellor's Ruling
in Harff.

In making his dismissal ruling, Judge Owen erroneously cited the Chancellor's decision in Harff for the black letter proposition that a fiduciary duty is owed by a corporation and its directors to corporate stockholders but not to bondholders, since the latter are not owners but merely creditors of the corporation. That was a manifest error, for the applicable principle of law set forth by the Chancellor was that the rights of debenture holders against the corporation and its management "are confined to the terms of the Indenture Agreement pursuant to which the debentures were issued" and the holders may not "maintain an action [in equity] against management for violation of rights which exist independently of the Indenture Agreement" "unless there are special circumstances which affect the rights of the debenture holders as creditors ..., e.g., fraud, insolvency, or a violation of a statute." (Emphasis supplied.)

In Harff, the Chancellor concluded that no such "special circumstances" had been alleged and that the class action claim based upon an alleged breach of fiduciary duty

must be dismissed. In the present case, such "special circumstances" were clearly and persistently complained of and presented to the court for adjudication at trial. They included: (a) allegations of fraud, (b) allegations of balance sheet insolvency (and a virtual certainty of insolvency in the bankruptcy sense if the proposed sale had not been consummated), (c) a violation of statute [Sec. 14(a)], and (d) further "special circumstance" in this case, namely, the unique offer by Dasa management of a new conversion price in exchange for the bondholders' consent to amendment of the indenture and sale of virtually all the company's remaining physical assets.

Thus in the present case Judge Owen made a manifest error of law in his interpretation of applicable Delaware law as set forth by the Chancellor in Harff, and in his application of that law to the facts and allegations of the case before him.

5. Prejudicial Errors on the Admissibility of Evidence and on Plaintiffs' Right Under the Federal Rules to Make an Adequate Record for Appeal.

Under Rule 43(c) where the trial is to the bench and an objection is sustained to a question, counsel propounding the question may request that the answer be taken for the record. In such a situation "the court upon request shall take and report the evidence in full, unless it clearly appears that the evidence is not admissible on any ground or that the witness is privileged." See, 6 Wright & Miller, Federal Practice and Procedure, Sec. 2414. Plaintiffs maintain

that their rights under that rule to create an appropriate record on appeal were repeatedly violated by the district court, particularly in connection with the testimony of Browning, Bellemore and Roy Brewer, when it denied reasonable requests that answers be included in the record and refused to make an express ruling that the evidence was "not admissible on any ground."

Plaintiffs also maintain that the district court exceeded the proper bounds of its authority in connection with the exclusion of expert testimony offered for the benefit of the trial court and for the appellate record. Rule 43(a) establishes a policy in the federal rules generally favoring the admissibility of evidence if reasonable grounds for its admission are presented. The general rule is that expert testimony is admissible where the issues to be determined are complex and beyond the experience of ordinary men and in which the specialized knowledge of a qualified expert will be helpful to the trier of the case in reaching the conclusions required by the facts and the law. Dougherty v. Milliken, 163 N.Y. 527, 533 (1900); U.S. v. Hiss, 88 F.Supp. 559 (S.D.N.Y. 1950); Sirico v. Cotto, 67 Misc.2d 636, 324 N.Y.S.2d 483 (Civil Ct., N.Y.Co., 1971, Younger, J.); 4 Wigmore, Evidence, Sec. 1192 [3rd ed. 1940].*

At the present trial, involving what Professor Bellmore found to be the most complex investment decision ever

* T-SCB-6-18, citing Goldwater v. Ginn, 414 F.2d 324, 343 (2d Cir. 1969); U.S. v. Williams, 447 F.2d 1285, 1290 (5th Cir. 1971); 21 N.Y.Jur., Evidence §§391 et seq.; T-SCB-61, 24, 146-155, 157-165, 168-171, 173-177, 70-72, 34-35, 43-44, 64 vs. 74-84.

recorded in the history of corporate finance and one involving an area of specialized knowledge (convertible securities values) beyond even the expertise of most securities analysts, the district court erroneously concluded that the issues involved in the fairness or worthlessness of the offer made to the bondholders were so self-evident as to be within the general experience of an average person and thus a subject on which expert testimony would be of no assistance to the court. In so concluding he effectively precluded plaintiffs from making an effective appellate record with respect to the testimony of Browning and Bellemore. [For the substance of the testimony Dr. Bellemore would have given if he had been permitted to testify, see PX-112.]*

* Despite the crucial importance of Judge Owen's mid-trial dismissal of the fiduciary duty theory based upon Harff as effectively breaking the back of plaintiffs' case (both substantively and procedurally), there is, strangely, no mention of that linchpin ruling anywhere in the court's post trial opinion filed on 1-12-76. In plaintiffs' post trial memorandum dated 7-14-75 opposing DASA's application for attorneys' fees, they had argued, quite correctly, that the very existence of the Chancellor's decision in Harff conclusively established the substantial nature and bona fides of the fiduciary duty theory of Claim 3, for in that case the same fiduciary duty theory was seriously argued by major law firms and seriously considered by the Chancellor. Given (i) the pivotal impact given by Judge Owen at the trial to the Chancellor's decision in Harff and (ii) the argument subsequently based upon that case by plaintiffs' counsel, the omission of any reference to that ruling or to Harff in the post trial opinion suggests (a) that the district court itself had doubts in retrospect about the correctness of its mid-trial ruling and consequently wished to avoid attention being given to it on appeal and (b) that the district court recognized the merit of plaintiffs' argument (that Harff indicated merit rather than speciousness in the fiduciary duty aspect of the present case) but rejected the notion of acknowledging that fact in its opinion because to do so would have substantially weakened or precluded altogether Judge Owen's decision made long before the trial to find plaintiffs' entire case lacking in merit and to award counsel fees to DASA. Clearly, if the fiduciary duty claim had reasonably arguable merit, which obviously it did, DASA could not be awarded attorneys' fees in exercise of the court's general equity powers.

POINT II

THE TRUSTEE BANK OWED A FIDUCIARY DUTY TO THE BONDHOLDERS, IN THE ABSENCE OF A DEFAULT UNDER THE INDENTURE, TO TAKE AFFIRMATIVE ACTION TO PROTECT THEIR INTERESTS FROM FRAUD AND OVERREACHING BY DASA BECAUSE SECTION 315(d) OF THE TRUST INDENTURE ACT FORBIDS INCLUSION IN THE INDENTURE OF ANY PROVISION THAT WOULD LIMIT SUCH A DUTY TO POST-DEFAULT SITUATIONS.

1. The Statutory Issue

Section 315(d) of the Trust Indenture Act of 1939, 15 U.S.C. §77000(d), provides that

"The indenture...shall not contain any provisions relieving the indenture trustee from liability for its own negligent action, its own negligent failure to act, or its own wilful misconduct. except that - (1) such indenture may contain the provisions authorized by paragraphs (1) and (2) of subsection (a)."

Section 315(a) provides that

"The indenture...may provide that prior to default (as...defined in such indenture) - (1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture."

Thus the following pure question of law is presented in this action with respect to Claim 4 against the bank: May Section 315(d) properly be interpreted as authorizing under "subparagraphs (1) and (2)" indenture provisions which abrogate entirely the otherwise applicable fiduciary duty of reasonable care imposed both before and after default upon a trustee and thus immunize the trustee completely from liability for improper fiduciary conduct prior to default?

The legislative history of Section 315 and of the Act as a whole clearly supports the interpretation urged by the plaintiffs upon this Court and upon the court below, which is that an indenture trustee is precluded by §315(d) from limiting or eliminating by contract in the indenture the fiduciary duties otherwise imposed by common law equity principles recognized by Congress and the courts when the 1939 Act was passed. House Report 1016, 75th Congress; Morris v. Cantor, 390 F.Supp. 817 (S.D.N.Y., 1975, Ward, J.)*

Plaintiffs' arguments to the court below on the statutory issue were more than reasonable and cogent. They were persuasive and correct in urging the existence of a pre-default fiduciary duty on the part of the trustee bank. In its arguments to the district court, the bank flatly denied the existence

* The merits of plaintiffs' case on this question were ably and cogently argued in plaintiffs' affidavit below (sworn to 8-21-75) in opposition to the bank's motion for a judgment awarding attorneys' fees, to which an appendix was attached citing authorities under parallel common law equity principles for a fiduciary duty on the part of a trustee independent of the indenture requiring it to give its beneficiaries notice of any matter essential to the preservation of their rights. "Mortgage Trustee -- Duty and Liability," 90 A.L.R. 2d 501, 506, 532 (1963); Young v. Howard, 120 F.2d 712 (D.C. Cir. 1941); People ex rel Barrett v. Central Republic Trust Co., 300 Ill. App. 297, 20 N.E. 2d 999 (1939); Bilton v. Lindell Tower Apartments, Inc., 358 Mo. Rep. 209, 312 S.W. 2d 952 (1943); Streight v. First Trust Co., 133 Neb. Rep. 340, 275 N.W. Rep. 273 (1937); First Trust Co. v. Carlsen, 129 Neb. Rep. 333 (1935).

See also, Caplin v. Marine Midland Grace Trust Co., 406 U.S. 416, 439 (1972) (Statement by Douglas, J., dissenting, that "the Trust Indenture Act of 1939 . . . gives no immunity" to a trustee charged with breach of fiduciary duty. Majority opinion indicates nothing to the contrary.); Kusner v. First Pennsylvania Corp., supra, (Re right of bondholders to sue outside the indenture).

of such a duty as a matter of law. The district court erroneously refused to recognize the bank's fiduciary duty because it refused to face and decide the statutory issue presented by Claim 4.

2. The district court's avoidance of the statutory issue and its dismissal of Claim 4 based upon plaintiffs' known financial inability to post a \$25,000 undertaking for the bank's counsel fees.
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A ruling in favor of the bank on the statutory issue, made pursuant to a Rule 12 (b) (6) motion to dismiss, would have eliminated the bank from the district court proceedings and left a clear-cut issue for resolution on appeal. Such a motion could have been made at any time by the bank and would have been welcomed by plaintiffs as an expeditious way to resolve this dispositive issue. No such motion was ever made, thus indicating that the bank considered the issue a reasonably debatable one on which it did not want to risk losing on the merits of a dismissal motion. Instead of so moving, the bank moved three separate times (without any reasonable basis for arguing that plaintiffs' theory on Claim 4 was without merit) for an order requiring plaintiffs to post a surety bond for its attorneys' fees. The last such motion was made several days before the scheduled trial date of May 5 and was granted in an order filed on 4-16-75 (op. #42,254)* (granting permission to renew the earlier motion) *RD 38 and an order filed on 4-21-75 (op. #42,276)* (requiring the posting of an undertaking of \$25,000 not later than 4-25-75). *RD 90 When the motion for an undertaking was granted, the court was advised that plaintiffs' counsel had consulted a surety company,

that they would be required to post full cash to secure the undertaking, and that they could not afford to do so. The court therefore knew that it was imposing a "means test" upon continuation of the suit against the bank. Upon their failure to post the bond and on 5-12-75, Judge Owen signed a judgment dismissing the action as against the bank on the merits, with prejudice and with costs.*

In Morris v. Cantor, supra, Judge Ward carefully examined the legislative and judicial history of Section 315(d) in the context of an alleged pre-default breach of fiduciary duty and concluded that "the legislative history suggests that Congress considered the existing body of common law sufficient to protect investors, so long as the trustee was precluded from contractually limiting the duties it imposed upon fiduciaries" (emphasis supplied) and that "Congress expressly anticipated that any liability indirectly imposed would be enforced by private civil actions." He held that "the statute was intended to create liability for breach of the indenture provisions, and for breach of fiduciary obligations which it expressly preserved from limitation by contract" and that the "area of residual liability ... is defined by the common law as it had developed prior to the statute."**

* Pages 160-171 of our brief dated 3-7-77 describe the completely unfounded reasons given by Judge Owen in his post-trial opinion (#43, 701; RD 115a, filed 1-12-76) for requiring the \$25,000 undertaking and describe also Judge Owen's tortuous but resolute avoidance of deciding the merits of the issues presented by the claim against the bank.

** See Rosenfeld v. Black, 445 F.2d 1337, 1343-45 (2d Cir. 1971), cert. dismissed, 409 U.S. 802 (1972) (federal standards of fiduciary duty incorporate common law principles); Accord, Galfand v. Chestnut Corp., F.2d (2d Cir. 11-4-76), N.Y.L.J. 11-19-76, p. 1. (n. 10).

We submit (1) that the logic of those conclusions is highly persuasive and requires a conclusion by this Court in favor of the plaintiffs and against the bank on the dispositive question of law involved in the claim against the bank and (2) that the dismissal of that claim must be reversed with instructions on remand for the bank to be held jointly liable with Dasa for the breach of fiduciary duties owed by each of them to the bondholders in the circumstances here presented.

We would make one additional point concerning the patently erroneous device employed by the lower court in this case of forcing dismissal of a substantial and potentially meritorious claim by requiring the posting of a surety bond which the court well knew was beyond the financial capacities of the plaintiffs to put up and still continue to prosecute the action. Given the district court's patent reluctance to grapple with the merits of the dispositive statutory issue and its inexplicable refusal even to acknowledge that Morris v. Cantor had been cited to it as a relevant and (by virtue of its persuasiveness) controlling authority, an inference is permissible in the circumstances of this case that the device of requiring a surety bond was used improperly and in excess of the district court's discretion under Section 315(e) of the 1939 Act for the purpose of imposing a means test upon the presentation of reasonable claims for adjudication in the federal courts under the securities laws. The impermissible character of a threshold requirement of great wealth as a precondition to adjudication of a fair claim against a bank under federal law is manifest.

Moreover, there is an apparently unintended irony in the district court's repeatedly relying upon a distorted reading of the record for the purpose of criticizing plaintiffs' statutory claim as lacking in "precedential support," while at the same time the court undertook an action that was completely without precedent under any of the federal securities laws in requiring an undertaking that was punitive in character and patently calculated to force dismissal of plaintiffs' claim against the bank without a clear-cut ruling on the merits of that claim. The abuse of discretion was twofold in nature: (1) there was an abuse of discretion under Section 315(e) in that the court was patently mistaken in concluding that the statutory fiduciary duty claim under Sec. 315(d) was "without merit" and (2) there was an abuse of discretion in dismissing plaintiffs' parallel state equity claim "outside the indenture" for failure to post a bond under the Trust Indenture Act, for the district court had no jurisdiction under the federal statute to make the posting of an undertaking a condition to prosecution of a "pendent jurisdiction" state equity theory of recovery based upon the same facts alleged as violative of the federal statutory duty.

It should be noted that the purely legal nature of the claim against the bank was thoroughly discussed with "indenture counsel" for the bank prior to and concurrently with filing of this action. And a letter was sent by the bank's counsel to plaintiffs' attorneys before the suit was commenced [PX-50, dated 2-16-72] precisely for the purpose of stating clearly "for the record" that the bank was making no effort to act on

behalf of the bondholders pursuant to any predefault fiduciary obligation but was relying exclusively upon the absence of any such duty as a matter of law and upon the exculpatory provisions in the indenture purporting to limit or to preclude any such duty.

It is of course evident from the foregoing that Claim 4 against the bank was neither frivolous nor vexatiously prosecuted against the bank, and the award of attorneys' fees to the bank must be reversed for that reason.

POINT III

IT WAS ERROR FOR THE COURT BELOW TO DISMISS
THE ACTION AS TO ANDERSEN PRIOR TO THE TRIAL.

1. There was ample notice to Andersen in the complaint and in the course of the proceedings in the action, that plaintiffs were charging Andersen with having certified improperly and aided in the preparation of audited financial statements incorporated in both the 1971 annual report and the March 9 solicitation letter.

The complaint was drafted in March 1972, well prior to denial of the pivotal temporary injunction motion on 5-8-72. Because relief was sought directed at both the 1972 stockholders' meeting and the bondholder solicitation through M-9, Claims 1 and 2 were formally directed at the former relief and Claim 3 was directed at the latter. However, the complaint was drafted with the intention of giving "notice" of what was complained of without unnecessary repetition. Consequently, so called "derivative action allegations" and "class action allegations" applicable in different ways to all of the claims were stated early in the complaint and before Claim 1.* Similarly, the same

*RD 1,3

Dasa financial statements audited as of 10-31-71 and delivered by Andersen to Dasa in early January of 1972 were included in both the 1971 annual report* (sent to stockholders, including plaintiff REB) and in M-9** (also sent to REB as a bondholder). *PX 32 ** PX 4

To avoid redundancy, the allegations in Claim 2 with respect to defects of disclosure in the 1971 balance sheet, Andersen's "qualified" certification of it, and inclusion of the \$1.5 million asset on it were not realleged in Claim 3, nor did plaintiffs' counsel consider it necessary in Claim 3 to formally "repeat and reallege" the facts stated in Claim 2. That was considered unnecessary under "notice pleading" concept of the federal rules. Counsel believed that "notice" had been reasonably given that plaintiff REB intended to claim in both of his capacities as a Dasa security holder that a balance sheet in violation of the proxy rules and Dasa's fiduciary obligations had been distributed to him and that Andersen had prepared and certified those statements improperly and thus shared with Dasa any liability that might arise from unlawful defects in them. Browning, of course, was complaining of M-9 only, since he owned no stock.

Also to avoid redundancy, Claim 4 (against Andersen only) did not include any of the allegations previously stated and applicable to false reporting for which Dasa and Andersen shared responsibility. Claim 4 included allegations considered applicable to Andersen only in its capacity as independent auditor. Claim 4 also indicates that Andersen was believed to have violated a duty to Dasa by virtue of its retainer contract as auditor, a duty owed derivatively to the Dasa stockholders,

including REB. Although not expressly pleaded as a theory of recovery (but implicit in the allegations of the complaint) was the argument that Andersen also owed a statutory duty to the stockholders and the bondholders by virtue of Section 14(a) and the Proxy Rules --- particularly the rules forbidding the distribution of financial statements unless independently audited. Schwartzman v. Tenneco Mfg. Co., 319 F.Supp. 1278, 1282 (D. Del., 1970, Latchum, J.) ("Inducing individual stockholders, by means of a proxy statement violative of Section 14(a), to vote for a ... [transaction] which causes them economic injury gives rise to a direct cause of action for damages."); Gissen v. Colorado Interstate Corp., 62 F.R.D. 151 (D. Del., 1974, Latchum, J.) (Action under §14(a) against, among others, the corporate auditor alleging certification of deceptive financial statements. On motion of the auditor to dismiss on the face of the complaint, held: motion denied.). *

Anderson never sought any discovery, as it was obligated to do under the federal civil rules, for the purpose of determining which allegations of the complaint were meant to apply to it and what theories of recovery plaintiffs considered to be

* See also: Herzfeld v. Laventhol, Krekstein, Horvath & Horvath, 378 F.Supp. 112 (S.D.N.Y., 1974), aff'd in pertinent part, F.2d (2d Cir. 1976), CCH Fed.Sec.L.Rep. ¶95,660 (Assessment of damages under §10(b) by an auditor for certifying a materially deceptive financial report affirmed.); Competitive Associates, Inc. v. Laventhol Krekstein, Horvath & Horvath, F.2d (2d Cir. 1975), CCH Fed.Sec.L.Rep. ¶95,090 (Dismissal of a §10(b) suit reversed.); Nat. Home Products, Inc. v. Gray, F.Supp. (D.Del., 1976, Latchum, J.), CCH Fed.Sec.L.Rep. ¶95,752 (Attorney held liable under §14(a) and a standard of negligence for preparing a materially deceptive proxy statement.); Lewis v. Black, F.R.D. (E.D.N.Y., 1976, Mishler, C.J.), CCH Fed.Sec.L.Rep. ¶95,715.

involved in the action and expected to rely upon at trial. Anderson counsel did realize that such inquiry was appropriate, because they inquired informally of plaintiffs' attorney (after Claims 1 and 2 had been dismissed by Judge Griesa) what claims Andersen was involved in and were advised that Claims 3 and 4 were involved. In a letter to Judge Owen dated 4-16-75 and written after argument of its motion to dismiss, Andersen's counsel stated clearly its understanding that plaintiffs' counsel was contending "that inclusion in ... [the March 9] letter of DASA's audited financial statements precludes dismissal of Claim 3 as against Andersen" because "in this regard ... the complaint attacks those financial statements." Notice of plaintiffs' attack on the financial statements as it had evolved during the litigation had been given in plaintiffs' memorandum dated 4-7-75* in opposition to Andersen's motion and, previously, to all opposing counsel in plaintiffs' appellate brief on Claims 1 and 2 dated 2-10-75 (pp. 13-17), some four months before the trial and two months before Andersen moved for dismissal. At page 17 of that brief, plaintiffs stated:

"In Claim 5 Roy Brewer alleges as a stockholder that Andersen is liable for violations of Section 14(a) and Proxy Rule 14a-3(b) involved in the financial statements contained in Dasa's 1970 and 1971 proxy materials, and the plaintiff bondholders ... allege similar violations in the financial statements incorporated in the 1972 solicitation materials sent to the bondholders."

Thus plaintiffs gave ample notice of what the intended thrust of their claims against Andersen was, even though Andersen sought no discovery. They intended to claim under Claim 3

* RD 84, 84a.

proxy rule disclosure violations in the M-9 financials and to claim liability both derivatively and directly. See, Sundstrand Corp. v. Standard Kollsman Industries, Inc., 488 F.2d 307 (7th Cir. 1973); Conley v. Gibson, 355 U.S. 41 (1957); U.S. v. Employing Plasterers Assoc. of Chicago, 347 U.S. 189 (1954); Rules 1,8(a), and 15, F.R.Civ.P.* The complaint could have been amended instead of being dismissed on Andersen's motion before trial [Indemnity Ins. Co. v. Browning Ferris Mach. Co., 227 F.2d 804, 809 (5th Cir. 1955) ("[R]ule 15(b) gives substantial latitude to amend," even after trial.); Bryan v. Austin, 354 U.S. 933 (1957); Brown v. Ward, 438 F.2d 1285 (4th Cir. 1970); Thomas v. Medesco, Inc., F.Supp. (E.D. Pa., 1974, Davis, S.D.J.), 19 F.R. Serv.2d 633], but in light of adequate notice having been given of what was claimed there was no requirement that plaintiffs' make such a motion. Indeed, if they had, Judge Owen would probably have construed it as an unreasonable attempt to seek delay of the trial.

2. It was error for the district court to dismiss the action as against Andersen.

The first error in this connection was in construing the complaint strictly and rigidly against the plaintiffs and in considering the four corners of Claim 5 as isolated from the earlier allegations in the complaint and as unaffected by plaintiffs' theories of recovery against Andersen as they had evolved over the course of the litigation and been disclosed

* See Kusner, supra (3d Cir. 1976) (concurring opinion of Rosen, J.), where additional, unpleaded theories of recovery for consideration by the district court on remand were suggested by the Third Circuit.

months before. Here Judge Owen clearly violated the holding of Sundstrand, supra, and the spirit of Rules 1, 8 and 15, F.R.Civ.P. If the court wished to take a strict view of the complaint, it should have granted leave to amend without adjourning the scheduled trial date.

The second error was in construing Claim 5 as if it was derivative only and then dismissing that claim, in part upon the highly technical and erroneous ground that there was absent from the complaint the allegation of a demand upon the corporation to sue Andersen that had been refused. [Op.#42,277,* pp. 2-6; Op. #43,701,* pp.3-4.] The claim was not exclusively derivative. There was a theory involved of direct liability on Andersen's part to the bondholders under Section 14(a) and the Proxy Rules. Schwartzman, supra; Gissen, supra. Even if the claim had been exclusively derivative, (a) the complaint did, in fact, contain Rule 23.1 "derivative action" allegations and (b) since Andersen was charged in essence with violating Section 14(a) directly and with aiding and abetting Dasa in the distribution of proxy materials containing deceptive financial statements, a demand upon Dasa that it sue its alleged joint tortfeasor would have been presumptively futile and would not have been required under controlling principles of law. Barr v. Wackman, 36 N.Y. 2d 371 (1975); Boyko v. The Reserve Fund, Inc., F. Supp. (S.D.N.Y., 9-30-75, Gagliardi, J.), CCH Fed. Sec. L. Rep. ¶95, 304; In re Kauffman Mutual Fund Actions, 479 F.2d 257 (2d Cir. 1957).* In Kauffman, this Court held that "mere approval

* See also: Berkwich v. Mencher, 239 F.Supp. 292 (S.D.N.Y. 1965); Freedman v. Barrow, F.Supp. (S.D.N.Y., 1976, Brizant, J.), CCH Fed.Sec.L.Rep. ¶95,754.

of the corporate action, absent self-interest or other indication of bias" is insufficient to excuse demand. But in the present action, bias, self-interest on the part of controlling directors in deceiving the bondholders in offering a worthless conversion price and concealing the severity of the company's asset depletion were alleged and charged against the Dasa directors.

Dismissal for failure to allege any connection between the deceptive financial statements prepared and certified by Andersen and any damages resulting to the plaintiffs was patently wrong. [Op. 42,277,* pp.2-3; *RD 91 Op. 43,701,* pp.3-4.] Berman v. Thomson, 312 F.Supp. 1031 *RD 115a (D. Ill., 1970 Austin, J.) (Statutory policy under §14(a) as interpreted in Mills, "vindicates the statutory policy of full disclosure and furnishes an important means of enforcement of the statute. Therefore, a plaintiff who can prove violation of the proxy statute is entitled to a judgment regardless of financial injury." There is no need to supplement the requirement of materiality with a requirement of whether the defect in disclosure actually had a decisive effect on the voting.); accord, du Pont v. Wyly, 61 F.R.D. 615, 629 (D.Del., 1973, Stapleton, J.) ("The theory of corporate democracy which underlies the private right to enforce Section 14(a) ... is incompatible with the notion that a shareholder has an enforceable right to honest proxy materials only when transactions approved by a shareholder vote in which he was misled ... [have] resulted in economic injury to him," citing J.I. Case v. Borak, 377 U.S. 426 (1964).) If the bondholders were deceived by M-9 into giving consents which

they might have withheld (had they been told the truth) for the purpose of either putting Dasa immediately into Chapter XI or holding out for a higher conversion price, then according to plaintiffs' expert witness the bondholders collectively were substantially damaged, for there were some 6,000 bonds outstanding and each one was worth \$367 less by virtue of the deception perpetrated than it would have been had the full truth been told in connection with the solicitation. In any event, possible difficulties in determining damages are no proper basis for dismissal of a complaint any more than they are for refusal to grant class action certification. Gissen, supra; Tucker v. Arthur Andersen & Co., F.R.D. (S.D.N.Y., 1975, Werker, J.), 20 F.R.Serv. 2d 4111 (Class action certification awarded in an action against Andersen despite a similar argument that damages might be difficult to prove.); see also Rosen v. Dick, F.R.D. (S.D.N.Y., 1975, Metzner, Jr.), 20 F.R.Serv. 471, where discovery was allowed of an auditor's records in an action based upon defective certification of financial statements based upon failure to apply reasonable accounting standards.

The third error was the most significant. That error was in the conclusion of law that "there is no right of action against one who does not "solicit" within the meaning of [Section 14(a)]," i.e., that the federal law under Section 14(a) does not recognize a claim against a certifying auditor for improperly certifying deceptive financial statements and thus facilitating their distribution as part of proxy solicitation materials. No

matter how flagrant or how damaging the proxy fraud or how central to its commission the financial statements prepared and certified by the auditor actually were, there can be, according to the district court's reading of the law, no secondary "aiding and abetting" liability imposed under Section 14(a) *RD 91 upon the auditor. In Opinion 42,277* (filed 4-21-75), the court cited Gould v. Hawaiian American Steamship Co., 351 F.Supp. 853, 865 (D. Del. 1972); Robbins v. Banner Industries, Inc., 285 F.Supp. 758 (S.D.N.Y., 1966); and Iroquois Industries, Inc. v. Syracuse China Corp., 417 F.2d 963, 970 (2d Cir. 1970), for the proposition (stated in Gould at 865) that "Section 14(a) imposes liability on individuals soliciting proxies, and not on the attorneys or accountants preparing them." In its letter to the district court of 4-16-75, Andersen's counsel emphasized that "the fundamental ground for our motion to dismiss Claim 3 [as to Andersen] is that no Section 14(a) cause of action exists because plaintiffs concede Andersen did not engage in any solicitation of proxies." *

However, when the district court wrote Opinion 43,701, RD115a some nine months later (filed 1-12-76), all reference to the nonexistence as a matter of law of a Section 14(a) claim against a certifying auditor as a participant in the solicitation was conspicuously omitted and reference is made only to the purported failure to make a Rule 23.1 demand for suit and the purported technical failure to spell out an explicit theory of damages in the complaint. Section 14(a) is a rapidly expanding

* Contra, Nat. Home Products, supra. See also, Herzfeld, supra; Competitive Associates, supra; Meer v. United Brands Co., CCH Fed. Sec. L. Rep. ¶95, 893 (S.D.N.Y., 2-17-77, Carter, J.).

area of the law, and the district court's apparent abandonment in 1976 of the main ground for the 1975 dismissal as to Andersen on the law is a clear indication that Judge Owen came to realize in the months that passed before his final opinion that a claim would now be recognized in this circuit against Andersen on the theory of direct liability under Section 14(a) and the M-9 financials that plaintiffs were seeking to prove at trial and did in fact prove, even though Andersen was not a party to the trial.

In fact, this Court's opinion in Iroquois, supra, did not involve the question of whether or not a direct claim of statutory liability for participating in a proxy solicitation in violation of Section 14(a) can be sustained against an independent auditor who knowingly certifies deceptive financial statements and thus facilitates the unlawful solicitation. In Iroquois the complaint dismissed below did not allege that "any defendant" solicited any proxy or consent. Consequently, the question raised here whether a claim may properly be stated under the statute against an accountant for certifying a deceptive balance sheet incorporated in a proxy statement is an open question in this Circuit, and, indeed, in all circuits.

In connection with the appeal from the dismissal as to Andersen, that issue must be faced and decided by this Court on this appeal. In light of the congressional policy embodied in the statute, as held in Mills and J. I. Case and discussed above, that issue should be decided in favor of the plaintiffs and in favor of the recognition of such a statutory claim.

This Court should reverse the dismissal as against

Andersen, indicate in its opinion that on the documentary evidence, offered expert testimony, and briefs below a prima facie case for liability under Section 14(a) was made out at trial against Andersen on the ground that it is per se deceptive and improper for even a "qualified" certification to be issued by an auditor where the true facts are that according to generally accepted accounting principles 20 percent of the corporate assets listed on the balance sheet do not in fact exist for auditing purposes and cannot properly be certified. If a "qualified" certification opinion could not properly be issued where 50 or 60 percent of the assets on the balance sheet are fictitious and not certifiable, then it is impossible to conclude rationally that such certification is proper where only 20 percent of assets are fictitious --- particularly where the "phantom asset" involved is kept on the balance sheet by management to conceal the fact that there is in reality a negative stockholders' equity and the corporation is insolvent on the balance sheet under any sensible accounting principles.

3. It was patently fraudulent and contrary to proper accounting practice for Andersen, by the issuance of a carefully "qualified" certification opinion, to permit Dasa to distribute, as part of a proxy solicitation statement, a balance sheet containing an intangible item representing 20% of total assets which Andersen in fact would not certify because it knew that such certification would be improper.

The SEC apparently learned, as a consequence of discussions with plaintiffs' counsel that in turn led to close questioning of Dasa and its attorneys, that Andersen had in fact refused to certify the \$1.5 million intangible. [PX-47] Consequently, 20% of the assets listed on the M-9 balance sheet

were in fact not "certified" as required by the Proxy Rules, but Andersen made it possible for Dasa to distribute that deceptive statement of assets anyway by issuing a partial certification containing a subtly-worded "qualification" of the opinion with respect to the 20% of nonexistent and uncertifiable assets.

The complete impropriety of Dasa's including a \$1.5 million "goodwill" item on its books at a time when it was operating on a deficit basis and had been doing so for some time is made clear in the authoritative work on corporate "auditing" or "certification" entitled Montgomery's Auditing (1957), pp. 296-297, 478-279. There "goodwill" is defined as "the cost of expected earnings in excess of a fair return" (p. 296). In the present case the assets were scheduled to be sold within a few months after the close of the 1971 fiscal year, so clearly there were no "expected earnings in excess of a fair return" reasonably attributable to the computers or services thereon because, except for a few short months, there would be no "expected earnings" from those assets or services at all. The authors of Montgomery's state clearly, where an excessive price is paid for a purchased subsidiary, that if there is any unjustifiable "excess of purchase price over net assets acquired" the "excess" should be allocated or written off promptly and not carried on the books: "The auditor should examine the corroborative evidence such as reports of company personnel or independent appraisers and correspondence to satisfy himself that the allocation of the excess cost is reasonable." (p. 478) Here Andersen apparently did that (or tried to do it)

and concluded that the allocation of \$1.5 million in excess cost as a "goodwill" item to the CTI service component (disconnected from the CTI computers to be sold) was not "reasonable." Consequently, the asset could not properly be shown on Dasa's books, but its management insisted on doing so anyway.

The reason why Dasa's management felt so strongly about the inclusion of this asset on its balance sheet is obvious to the expert financial analyst: without that asset on the balance sheet, Dasa was insolvent to the tune of \$1.4 million, and Dasa's management wanted to hide that insolvency and conceal it as much as possible from its stockholders and bondholders. And it proceeded to do so over the (rather mild) objections of Andersen and despite the fact that the inclusion of the asset was, as Andersen and Dasa's financial vice president well knew, improper, incorrect, completely contrary to generally accepted accounting principles and potentially fraudulent or seriously misleading to unsophisticated "average" Dasa security holders reading its financial statements with that false and "phantom" asset included.

Was it an exercise of "bad faith" for plaintiff Browning (who is an expert financial analyst and consequently aware of the fraud and impropriety involved in the Dasa balance sheet in the March 9 letter) to commence this suit complaining, in part, about the false and improper inclusion of that asset in the March 9 letter and in Dasa's 1971 annual report? Obviously it was not. The deception intentionally perpetrated by Dasa's management in that connection is crystal clear.

POINT IV

IT WAS ERROR FOR THE COURT BELOW TO DENY PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT AGAINST DASA ON THE STATUTORY THEORY THAT THE OFFER OF A 50% REDUCTION IN THE CONVERSION PRICE WAS AN OFFER TO CHANGE A SUBSTANTIAL FEATURE OF THE BONDS AND THUS AN OFFER OF A "NEW SECURITY" IN EXCHANGE FOR "VALUE" AND CONSEQUENTLY A NEW AND UNREGISTERED SECURITIES ISSUE IN VIOLATION OF SECTION 5 OF THE SECURITIES ACT.

1. The nature of the Section 5 claim and the substantive issues raised.

Section 5 of the '33 Act. Sections 5(a) and 5(c) of the '33 Act (15 U.S.C. 77e(a) and 77e(c)) provide as follows:

"Sec. 5.(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly ---

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

* * * *

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding of examination under section 8."

Section 3(a)(9). Section 3(a)(9) of the '33 Act provides as follows:

"Sec. 3(a). Except as hereinafter expressly provided the provisions of this title shall not apply to any of the following classes of securities:

* * *

(9) Any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange."

A. The Section 5 claim.

Plaintiffs claim that the M-9 solicitation and indenture amendment violated §5 was based upon the following argument:

(1) The offer of a 50% reduction in the conversion price was an offer by the issuer to change a substantial feature of the bonds, and such an offer constitutes an offer of a "new security" that must be registered unless exempted. 1 Loss, Securities Regulation Ch. 3A, pp. 512, 514.

(2) The M-9 solicitation was concededly not registered under the 1933 Act, and filing under the 1934 Act proxy rules does not constitute compliance with the registration requirement.

(3) The offer thus made was not exempted by Sec. 3(a)(9) as Dasa claimed because the requirement of substantial consideration from the bondholders in the form of their "consent" to the proposed indenture amendment and computer sale constituted a form of "payment" by the security holders for the offered "exchange" that made the Sec. 3(a)(9) exemption unavailable, since it was not a "free" offer to the security holders. SEC Rel. No. 33-1495 (7-1-37, 2 F.R.1382; CCH Fed.Sec.L.Rep. ¶2126, p. 2580.*

* The foregoing argument was made in two memoranda below, dated 3-7-75 and 3-27-75, RD 74, 80.

Dasa conceded that the offer was unregistered and made no response to the "new security" argument, thus conceding that the conversion price reduction was a change of a substantial term. It claimed the benefit of the 3(a)(9) exemption but ignored completely the requirement of that exemption that nothing more than an insignificant "adjustment" payment may be required from the offeree security holders. Thus, they argued (memo received 3-24-75, p.6), "if the Debentures with the reduced conversion price were a "new" security, the transaction was nothing more than an exchange of the Debentures with the old conversion price for an equal number...with the new price, effected by DASA exclusively with the Debenture Holders."

B. The substantive Issues

Thus the substantive merits of the Sec. 5 claim turned on two issues of law, the first of which was conceded by Dasa:

- (1) Was the offer of a reduced conversion price an offer of a "new security"?
- (2) If so, was the requirement of bondholder "consent" (to the computer sale and indenture amendment) as a quid pro quo for the new conversion price a requirement of "value" from the offerees that made the Sec. 3(a)(9) exemption inapplicable?

Despite the fact that Dasa had made no response to the "new security" argument, Judge Owen ignored the dispositive test set forth by Loss ("whether the rights of security holders have been...substantially affected by the particular change" [Vol. 3A, p. 514]) and concluded, (without mentioning Loss) that

plaintiffs' argument in this connection was "without merit" because (1) as he interpreted the underlying financial transaction, it involved an offer "beneficial to the holder" not to the holder's disadvantage; (2) the indenture contemplated a possible conversion price reduction; and (3) a proxy review filing had been made with the SEC. (Op. #42254,* filed 4-16-75) *RD 88

This reasoning was clearly erroneous in its assumption that "beneficial" amendments to the terms of a security do not fall within the "new issue" doctrine as explained by Loss. Consider the obvious example (also cited to Judge Owen) of an offer to warrant holders to extend the duration of their warrants by one year in exchange for payment of 10 cents per warrant. Such an amendment would clearly be "beneficial" to the security holder, for it would give him a longer time for the stock price to reach the warrant exercise price. Yet under clearly-established securities law and SEC practice, the requirement of even a one cent payment would take the offer out of the 3(a)(9) exemption and require a full 1933 Act registration. Plaintiffs' counsel has had to do precisely that a number of times. Second, the parties have no power in an indenture agreement to abrogate the Sec. 5 registration requirement. Third, a proxy review filing is not a substitute for a registration, and that is true whether the SEC proxy review staff overlooked the Section 5 problem or not. Proxy Rule 14a-9(b); Gerstle v. Gamble-Skogmo, supra; Subin v. Smith, 244 F.2d 753 (2d Cir. 1955), cert. denied, 350 U.S. 883 (1955); Dann v. Studebaker-Packard Corp., 288 F.2d 201 (6th Cir. 1961).

Here the bondholders' "consent" was clearly worth

more than one cent, and the 3(a)(9) exemption was thus clearly unavailable. In its opinion, the district court completely failed to deal with that problem, apparently because of its patent misunderstanding of the controlling principles of law under the Securities Act.

2. The procedural issues; the statute of limitations.

Dasa argued that the Sec. 5 theory was not only an "untenable theory of law" but a "claim" not previously pleaded and therefore barred from being considered on the merits by the one year statute of limitations in Sec. 13 of the Securities Act. The court below accepted that argument, in error. (Op. 42554*, p.2.)

Plaintiffs had given adequate notice in the complaint of the factual transaction complained of (the solicitation, amendment and sale) as violative of their rights. They were not limited to the 1934 Act theory of recovery expressly recited in the complaint, but were entitled to the benefit of another statutory theory of liability arising from the same transaction which had become known to them prior to or even during the trial.

"Under the Federal Rules...a party is not 'required to pick and stick to one theory of law...only to find when he gets to trial that he has chosen the wrong one.' Amendments may be made during and after trial under Rule 15, changing the theory on which the case is brought, and under Rule 54(c) the party is to be granted any relief to which he is entitled, even though he has not demanded it." 1 Moore's Manual of Fed. Practice and Procedure §10.04[z] (at 615), citing, inter alia, Clark, Code Pleading (2d ed. 1947) 259.

Here the complaint need not have been formally amended. It could, and should, have been deemed amended to encompass

the newly-discovered theory of recovery. Trial on that theory was unnecessary, since the issues presented were purely matters of law, and the statutory remedy of rescission would follow automatically from a decision favoring the plaintiffs. If the issue had remained open at trial there could not have been any conceivable prejudice to Dasa in preparing its defense. This motion was made three months before the trial.

If the pleadings had been appropriately "deemed amended" under Rule 15(b), the amendment would have related back to commencement of suit under Rule 15(c) and the statute of limitations issue would have been eliminated by a process contemplated and provided for by the Federal Civil Rules for precisely such a situation as this, to prevent the harsh effects of a short statute of limitations not favored by the law. "The first sentence of the rule [15(c)] is based on the idea that a party who is notified of litigation concerning a given transaction or occurrence is entitled to no more protection from statutes of limitations than one who is informed of the precise legal description of the rights sought to be enforced." 1 Moore's Manual, supra, §9.09[9] (p. 9-42), citing, inter alia, Tiller v. Atlantic Coast Line R.R., 323 U.S. 574 (1945). See Kusner v. First Pennsylvania Corp., supra (3d Cir. 1976), in which Judge Rosenn, concurring, suggested a new and unpleaded statutory theory of recovery to support the "cause of action" stated by the convertible bondholder plaintiffs and suggested that the lower court should consider this alternative theory on remand. Judge Owen's dispositive ruling below was completely inconsistent with the premises of Judge Rosenn's opinion.

POINT V

IT WAS CLEARLY ERRONEOUS AND SERIOUSLY
PREJUDICIAL FOR THE DISTRICT COURT TO
DENY WITHOUT OPINION OR STATEMENT OF
REASONS PLAINTIFFS' MOTION UNDER RULE
30(b), FRCP, FOR AN ORDER AUTHORIZING
PLAINTIFFS TO CONDUCT THEIR DEPOSITIONS
BY OTHER THAN STENOGRAPHIC MEANS.

By amended notice of motion docketed on July 17, 1974, and returnable on August 23, 1974,* plaintiffs moved, *RD 64
pursuant to Rule 30(b), FRCP, for "an order directing that
depositions taken on behalf of the plaintiff. . . may be
taken through the use of" multiple, simultaneous tape recorders
making duplicate original recordings of the proceedings,
"with (i) one such original to be kept by counsel for the
plaintiff and the other to be kept by counsel for the de-
fendant primarily involved in the proceedings and (ii) a typed
transcript. . . to be sent by counsel taking it to all counsel
in the action." **

** By letter dated July 19, 1974, plaintiffs' counsel advised Judge Owen and counsel for all defendants that plaintiffs would be willing to accept "in lieu or expansion of the specific procedure described in their motion papers" all or such parts as Judge Owen "may consider necessary or appropriate" of the procedure adopted in Lucas v. Curran, 62 F.R.D. 336, 339 (E.D. Pa., 1974, Green, J.) and cases cited therein at 62 F.R.D. 338. That motion was made some 46 weeks (more than 10 months) before trial of the action commenced, on June 2, 1975. It was denied in a handwritten memorandum by Judge Owen on plaintiffs' motion papers dated October 9, 1974, and docketed on October 11, 1974. (RD 64). The entire text of the memorandum was: "This motion is denied."

It was the intention of plaintiffs' counsel to conduct as many depositions as plaintiffs' limited funds would permit and as the circumstances of the case indicated to be necessary beginning with the following (listed in approximate order of importance):
(footnote continued on next page)

Because of plaintiffs' limited funds and the likelihood of having to fund at least two appeals and possible multiple trials of this action, their counsel could not afford to conduct depositions of any of the persons indicated above, or indeed any depositions at all, by the use of normal stenographic methods prior to trial on Claim 3. At the beginning of the trial, plaintiffs' counsel (i) objected to being forced to trial without the benefit of pretrial depositions as a consequence of the court's denial of tape recorded depositions and the plaintiffs' limited funds and (ii) stated that plaintiffs would proceed with the trial only under protest and at the direction of the court because of counsel's opinion that a fair and proper trial consistent with due process of law and his clients' procedural rights under the FRCP's could not and would not be possible in the circumstances. Judge Owen rejected the protest, refused to declare a mistrial, and directed the trial to proceed.

Prior to and during the trial, plaintiffs' counsel attempted to obtain the testimony at trial of Reichter, Bolivar, Tracy and certain other persons and to obtain the production of documents at the trial by Dasa, Andersen and the Bank of New York (the indenture trustee for the instant Dasa debentures) through the issuance of trial subpoenas and applications for

(footnote continued from previous page)

- (1) Richard Reichter, President and a director of NASA;
(2) Ronald Bolivar, Treasurer, Executive Vice President-Finance, and a director of DASA until several weeks before the trial in June of 1975; (3) Arthur Andersen & Co. by Daniel Tracy, a partner, and certain other partners and employees familiar with the fiscal 1971 audit of DASA and the certification by Andersen of its financial statements for that year; and (4) Robert LeBuhn, Ernest T. Greeff, Edgar B. Stern and Roderick A. Munroe, directors and former directors of DASA.

appropriate orders by the court. Judge Owen quashed all of the trial subpoenas and refused to order the production of documents at trial by Dasa, Andersen or the bank.

Reichter, Bolivar and Tracy all live in or around Boston or Andover, Mass. (where Dasa has its headquarters). If their depositions had been taken, they would probably have been taken in the U.S. Courthouse in Boston, with the result that the transcripts would have been admissible in evidence against Dasa under Rule 32(a), FRCP. Moreover, if Judge Owen had not denied the motion, Bolivar would have been deposed as an officer and director of Dasa, positions he held until some time around March of 1975. In addition, plaintiffs would have had the advantage at trial of documents produced in connection with the precluded depositions, answers to questions relating to such documents and leads to further evidence resulting from the precluded depositions.

The issues at the trial revolved around the state of Dasa's financial condition and the expected results of the 1972 computer sale as described in Reichter's letter to the Dasa stockholders in the 1971 annual report, in the 1972 shareholder proxy statement, and in the March 9 solicitation letter to the Dasa bondholders. The persons most knowledgeable about those subjects were unquestionably Reichter, Bolivar, and the responsible accountants in the Andersen firm who conducted the fiscal 1971 audit of Dasa, certified (in part) the financial statements in the 1971 annual report, and prepared and certified (in part) the financial statements of Dasa incorporated in the March 9 letter. As a consequence of the district court's

denial of tape recorded depositions, no testimony was available or presented at trial from any of those relevant sources, either live or transcribed.

Plaintiffs respectfully submit that, for all of the reasons set forth by Chief Judge Bazelon of the District of Columbia Circuit in Colonial Times, Inc. v. Gasch, 509 F.2d 517 (D.C. Cir. 1975), denial of plaintiffs' instant motion for permission to record deposition testimony by other than stenographic means was clearly erroneous, extremely prejudicial to the fair and proper trial of plaintiffs' case on Claim 3, contrary to the principles and policies embodied in Rules 1 and 30(b)(4), FRCP, arbitrary, and an abuse of the discretion of the district court in the circumstances. Indeed, arbitrariness and lack of reasoned judgment is more strongly indicated in the record of this case than it was in Colonial Times, for there the district judge undertook to set forth his reasons for denying the motion in an opinion, thus indicating some recognition of the purpose behind Rule 30(b)(4), however limited or incorrect. Here Judge Owen simply denied plaintiffs' motion in four words, thus indicating a complete failure to appreciate the purpose and policy of Rule 30(b)(4) and an apparent belief on the part of the district court that, despite the clear admonition to the contrary in Rule 1 (i.e. "these rules. . .shall be construed to secure the just, speedy, and inexpensive determination of every action"), a district judge may without abusing his discretion and without providing any written reasons require the transcription of

depositions by stenographic means in every case and any case before him regardless of the language of Rule 30(b)(4) and despite the absence of any significant or substantial reason for denying an application for transcription by other than stenographic means in a particular case.

Appellants' position as stated above is in no way inconsistent with or weakened by UAW v. National Caucus, 525 F.2d 323 (2d Cir. 1975), for that case involved express findings by a magistrate that the recording method there proposed was not likely to produce an accurate transcript, and the moving party did not object to those findings before the district court. Here there was no such record at all. On its face the district court ruling was completely arbitrary.

POINT VI

IT WAS ERROR AND AN ABUSE OF DISCRETION FOR THE DISTRICT COURT TO DENY PLAINTIFFS' APPLICATION FOR A DISCRETIONARY ORDER TRANSFERRING THIS ACTION FOR TRIAL TO ANOTHER JUDGE ON THE GROUND THAT JUDGE OWEN HAD PREJUDGED THE MERITS OF THE CLAIMS AND BECOME BIASED AGAINST PLAINTIFFS' COUNSEL.

1. The federal court policy against prejudgment of the merits of an action before trial.
-

There is a strong policy in the federal courts, established and recently reenforced by the Supreme Court, against prejudgment of the merits of an action by the district court judge prior to trial on the merits. Eisen v. Carlisle &

Jaquelin, 417 U.S. 156, 178 (1974). That policy is based upon the necessity to maintain, --- at all times and to the maximum feasible extent --- the appearance of even-handed and unbiased administration of justice in the federal court system. See 28 U.S.C. §§144 and 455.

There are strong indications in the present record of prejudgment of the merits and bias by Judge Owen prior to the trial in this case. Those indications are described in our brief dated 3-7-77 at pages 205-211. In brief, they may be found in the following documents and actions: (a) dismissal of the entire action on improper grounds on 9-16-74 (RD 68, 69, 69a); (b) opinion dated 4-16-75 denying plaintiffs' motion for summary judgment on Claims 3 and 4 (#42, 254; RD 88); (c) opinion filed 4-21-75 (#42, 276; RD 90) granting the bank's third motion for an undertaking.*

2. The undisclosed relationship between Judge Owen and the firm representing the defendant bank.

- (a) Participation by two partners of Sullivan & Cromwell in the process by which Richard Owen was recommended for appointment as a district court judge.

Richard Owen was recommended for appointment as a federal district judge by Senator Javits. In order to be thus recommended, his candidacy for the federal bench proceeded through a number of screening processes, any of which could

* In Hodgson v. Liquor Salesmen's Union Local No. 2, 444 F.2d 1344, 1348 (2d Cir. 1971), the Second Circuit stated that the policy behind Sections 144 and 455 is "to avoid the appearance as well as the actual existence of bias or prejudice on the part of the trial judge." See also, In re Millman, 439 F.2d 412 (4th Cir. 1971); Bradley v. School Board of City of Richmond, 324 F.Supp. 439, 444 (D.Va. 1971); Lawton v. Tarr, 328 F.Supp. 670 (D.N. Car. 1971).

have eliminated him from consideration. Among those screening processes were the following: (a) selection by the judicial screening panel of Senator Javits; (b) selection by Senator Javits from a small list submitted to him by his screening panel; (c) approval by the screening panel of Senator Buckley; (d) approval by a committee of The Bar Association of the City of New York; (e) approval by a committee of the American Bar Association; and (f) clearance by the Justice Department after an investigation conducted by the FBI.*

On 1-22-74, this action was assigned to Judge Owen, immediately after his appointment as a district judge. Two partners of Sullivan & Cromwell had been critically involved in the process of Judge Owen's appointment to the bench as members of the judicial screening panels of both Senator Javits and Senator Buckley. When this case was assigned to Judge Owen, neither Sullivan & Cromwell ("S&C") nor Judge Owen disclosed to plaintiffs' attorney the role played by its partners in his appointment. Nor did either the judge or the law firm disclose those circumstances as relevant to the issues raised by plaintiffs' motion filed 4-29-75 (RD 98, 101) for an order by Judge Owen voluntarily recusing himself and transferring this action

* The nature of this selection process was described in a series of articles in the New York Law Journal on September 7, 8, 9 and 10, 1976. Copies of those articles were filed in this Court as exhibits to appellants' motion filed 1-11-77 for an order sealing the fee award decisions below and disqualifying Sullivan & Cromwell from continuing to represent the bank because of its failure to disclose in the district court its close and critical involvement in Judge Owen's appointment to the bench.

to another judge for trial because of actual or apparent pre-judgment or personal bias on the part of Judge Owen against the plaintiffs and in favor of one or more of the defendants.

David Peck and Robert McCrate are both partners of S&C. McCrate served on the Javits judicial screening panel, and Peck served on the Buckley panel. *

Certainly Richard Owen, Robert McCrate, and David Peck all knew, when the former was appointed to the bench in January of 1974, that two partners of S&C had played a substantial role in the process that resulted in his appointment. To a layman---and to many lawyers as well---the appearance of bias and favoritism might reasonably be thought to have existed on the part of Judge Owen toward Sullivan & Cromwell on the facts of this case, including those set forth above and those involved in the highly unusual and absolutely unprecedented action taken by Judge Owen in granting S&C's motion that its client be dismissed from the action with prejudice not on the merits of the claims against it,--but because of the financial inability of the plaintiffs to post a \$25,000 surety bond for payment of the bank's counsel fees---fees which Judge

* On the present record, we do not know exactly what role either McCrate or Peck played in the action of his panel on the Owen candidacy. Perhaps before this appeal is decided a hearing should be held to determine those relevant facts. Appellants hereby request that such a hearing be directed in the discretion of this Court. We can reasonably assume, however, that vigorous opposition by either McCrate or Peck to the Owen candidacy would have been fatal.

Owen himself later fixed at \$7,000.*

(b) Appellants' argument.

Appellants' argument in this connection proceeds as follows: (1) S&C as a firm and McCrate and Peck as individual attorneys and officers of the district court had a legal, ethical and moral duty to disclose to plaintiffs' counsel the facts concerning the involvement of McCrate and Peck in Judge Owen's appointment. (2) When they failed to perform that duty, (a) it was reversible error as against their client in the action and a severe breach of legal ethics by the firm and both attorneys, for which this Court should commence appropriate proceedings against them** and (b) a duty was then placed on Judge Owen to disclose the relevant facts when the attorneys involved failed to do so which he violated, thereby committing both reversible error as to all defendants and a breach of judicial ethics, for which appropriate proceedings

* "An attorney should not only avoid impropriety but should avoid the appearance of impropriety." State ex rel. Nebraska State Bar Ass'n v. Richards, 165 Neb. Rep. 80, 93; 84 N.W. 2d 136, 145 (1957). See also, Winters v. Travia, 495 F.2d 839, 842 (2d Cir. 1976), where this Court stated that judicial conduct should always "help assure" the existence of "the appearance of justice" as well as its substance.

The appearance was created in this case, when the relevant facts became known long after the trial, that Judge Owen might have felt a debt of gratitude toward those who had recently contributed to his becoming a federal judge, especially in view of the fact that this action was one of the first assigned to him after he was sworn in.

** Commencement of such proceedings is hereby demanded.

should be commenced against him in or by the Judicial Conference of this Circuit.* (3) The lack of appropriate disclosure by either the attorneys or the district judge (a) deprived plaintiffs of the opportunity to consider moving for either mandatory or discretionary recusal under 28 U.S.C. §144 or 28 U.S.C. §455 and (b) created a significant potential that harm might be done to the appearance of justice in this action if the relevant facts should subsequently come to light, as they now have. (4) Regardless of whether disclosure "up front" in early 1974 would have required Judge Owen to recuse himself then as a matter of law, the facts are: (a) that there was no such disclosure and Judge Owen thereafter treated this action in an extremely one-sided fashion in favor of the defendants and most punitively against the plaintiffs, and (b) the combination of nondisclosure plus a clear and protracted display of unbridled hostility toward plaintiffs and their attorney creates a much larger problem of error and breach of ethics by counsel and the court than would have been created if timely disclosure had been made. It is much more serious for the problem to arise at this point, than it would have been if it had been raised voluntarily in January of 1974. (5) The counsel fees payable by the defendant bank to S&C were reimbursed by DASA pursuant to an arrangement which DASA and the bank maintained was required by the instant trust indenture (RD 1, Exh. G to the original complaint; PX-1), but which plain-

* Such proceedings are hereby demanded.

tiffs attacked (in motions erroneously denied below*) as contrary to the public policy reflected in the Trust Indenture Act and subversive of the trustee bank's duty to protect its beneficiaries, the DASA bondholders, from injury due to willful acts by DASA, such as plaintiffs alleged to have been done in this case. By virtue of the fact that DASA was paying the fees of S&C (and Judge Owen knew it), DASA was in a position to benefit from any favoritism Judge Owen might have been inclined to extend to S&C and its clients in this action. Through DASA's payment of the bank's counsel fees, the roles of counsel for DASA and the bank became inextricably and improperly entangled.

POINT VII

IT WAS ERROR FOR THE DISTRICT COURT TO DENY PLAINTIFFS' MOTION FOR CLASS ACTION DESIGNATION UNDER RULE 23. ANY POTENTIAL PROBLEMS ARISING OUT OF CLAIMS 1 AND 2 ON BEHALF OF THE STOCKHOLDERS CEASED TO EXIST WHEN DISMISSAL OF THOSE CLAIMS WAS AFFIRMED ON APPEAL.

1. The Motion and the Decision

Plaintiffs' class action motion was made by order to show cause (filed 5-19-72, RD 21), supported by a memorandum of law (filed 6-6-72, RD 25, 26, pp. 3-5) and denied in a decision filed on July 16, 1974 (Op. #40, 970, RD 63), more than two years

* RD 76, 77, 83, 88, 127 (¶60(b), p. 52; ¶¶81-82B, pp. 65-68), 29-page affidavit dated 8-21-75 of plaintiffs' attorney in opposition to the bank's fee motion (apparently missing from the record).

after the motion was filed.* That decision combined with the denial of economical tape recorded depositions to substantially break the back of plaintiffs' action with respect to further discovery. Because of those rulings, plaintiffs could neither (a) afford to conduct extensive depositions on their own nor (b) contact other potential participating plaintiffs for support.

Since neither ruling was appealable, plaintiffs had no choice but (1) to discontinue the action (and thus abandon their right to appeal, on behalf of themselves and the class, from crucial decisions they considered erroneous) or (2) to complete the action with the limited means available to them and thus preserve the individual and class claims as well as the right of appeal on the Rule 23 issue. They chose the latter course. In doing so, they considered the interests of the class as important as their own.

Judge Owen stated only one reason for denying plaintiffs' motion to represent the solicited bondholders as a class. As he stated it, the reason was that "the evidence shows that those same debenture holders have already rejected the relief the plaintiffs demanded." In fact, the "evidence" showed nothing of the kind. By way of explanation, the Court stated that:

"It is of critical significance ... that after the commencement of this litigation, DASA advised all debenture holders by letter that they could revoke the consent they had heretofore [sic] given in the light of the litigation. In response to this letter, the holders of only .3% of the principal amount of debentures elected

*The stockholders' class action claims (Claims 1 & 2) were dismissed in the same opinion. A final judgment was entered on the dismissal (RD 71, filed 10-15-74). An appeal was taken promptly but not decided by this Court until October 3, 1975, which was four months after the trial on Claim 3 against DASA.

to withdraw their previously filed consents. ... Thus the debenture holders were given an early opportunity to declare for or against the position the plaintiffs now assert here, and chose overwhelmingly to reject it. In view of the above, there is no class for the plaintiffs to represent." (Op., p4)

Four things are notable about that statement: (1) It has nothing whatever to do with any of the legal elements required for class designation under Rule 23. In fact, all of those requirements were clearly met by plaintiffs' application.* (2) It assumes, incorrectly, that the notice of possible revocation sent by DASA (at the insistence of the SEC) was the practical and legal equivalent of a notice under Rule 23 offering potential class members an opportunity to "opt out" of the class action and thus not be bound by (or entitled to benefit from) the result. See Korn v. Franchard, 456 F.2d 1206, 1209-10 (2d Cir. 1972); Miller v. Mackey Internat., Inc., 452 F.2d 424, 427 (5th Cir. 1971). The two situations are different in many material respects. (3) It ignores the timing of the notice of suit (on 4-21-76, while the motion for a preliminary injunction was pending) and the impossible dilemma of the solicited bondholders.** (4) The conclusion that there was "no class [of

*See verified complaint ¶¶(3)-(4), pp. 4-10 (RD 1, 8).

**There was no way for them to object to the inadequate conversion price without also preventing the proposed sale and sending DASA into almost certain bankruptcy. If they withdrew their consents in sufficient numbers, the computer sale would fail and the creditor banks or other creditors would be likely to commence insolvency proceedings. Thus many of them undoubtedly felt compelled to submit consents while either resenting (helplessly) the inadequate consideration or failing to understand why it was inadequate. The situation would have been different if the Browning Committee had been able to make a counter solicitation, for in response thereto the bondholders could have expressed their views and choices on the conversion price question. No such opportunity was presented. Moreover, many bondholders may have assumed (incorrectly) that if there was anything improper about the conversion price offer, the court would correct the impropriety in the pending proceedings without the necessity of their withdrawing consents previously submitted. The bondholders had no way of knowing in late April of 1972 that a federal judge acting two years later would interpret their failure to withdraw their proxies upon (continued on next page)

solicited bondholders] to represent" did not follow from the stated premises and was in fact patently false.

2. All of the requirements of Rule 23 were satisfied by plaintiffs' application

Rule 23(a). (1) There were between 400 and 500 solicited bondholders. Defendants conceded that the class was sufficiently numerous that joinder of all members was impractical. The court made no finding to the contrary. (2) Similarly, defendants conceded that there were questions of both law and fact common to the class.* They could not have done otherwise. Clearly the existence or nonexistence of a fiduciary relation between DASA, the trustee and Andersen on one side and the solicited bondholders on the other involved questions of law common to all solicited bondholders. The existence of material defects of disclosure also involved common questions of mixed law and fact. In substance, every question of law or fact raised in this action by the plaintiffs as bondholders was common to the class.

(3) The claims of the plaintiffs were typical of the solicited bondholders as a class. Defendants pointed to no fact other than REB's claims as a stockholder that distinguished any of the plaintiffs from the solicited bondholders as a class. That distinction was eliminated from the case when Claims 1 and 2

** (continued from previous page)

learning of the lawsuit as a choice on their part to "opt out" of the lawsuit and not receive any benefits from it. If the individual plaintiffs should prevail on the fiduciary duty issue and thus become entitled to the financial equivalent of a fair conversion price, it would be completely unfair if the other solicited bondholders were not to receive similar benefits.

*(See complaint, ¶¶(3)-(4) for a list of such questions.)

were dismissed and the dismissal was affirmed. Neither SCB nor attorney BRB ever owned any stock or had any interest different from the other solicited bondholders. (4) Except for the existence of disclosure claims on behalf of the stockholders (which plaintiffs maintained to parallel and not to conflict with the bondholders' claims for similar disclosure and which have now disappeared from the action), defendants pointed to nothing at all to indicate that the plaintiffs and their attorney would not "fairly and adequately protect the interests of the class."

There was no alternative to representation by one or more of these plaintiffs. The choice before the court was to have the bondholder class represented by the plaintiffs or not be represented at all and thus lose by judicial action even the choice of benefiting or not benefiting from the litigation. Plaintiffs and their counsel submit that they have in fact represented the class fairly, adequately and to the best of their ability, financial and professional --- Judge Owen's conclusions to the contrary notwithstanding. The District Court made no finding that either SCB or REB would not be a proper class representative. If Judge Owen considered BRB a plaintiff at that time, he did not indicate that or state any reason why BRB could not properly serve as counsel to the class. None of the defendants moved to have BRB ruled a plaintiff or to have him disqualified as counsel for the plaintiffs or for the bondholder class.

*RD 115a

In the much later opinion of 1-12-76,* Judge Owen held that

BRB was a plaintiff in the action. Appellants challenge that conclusion as error because BRB was never a named individual plaintiff and his participation in the name-only Browning Committee was an insufficient connection to make him a party to the action. BRB was not named as a plaintiff precisely because of his necessary and unavoidable role as attorney and because of his desire not to be both a plaintiff and plaintiffs' attorney.

Appellants submit that this Court should expressly (a) conclude that BRB is not a plaintiff and (b) state that he may properly act as counsel for the plaintiff class in subsequent proceedings in the court below, even though he is a member of the class.*

Rule 23(b). Similarly, one or more of the alternative requirements set forth in Rule 23(b) was satisfied by the plaintiffs' application.**

3. The reason given below for denying the class action motion was unfounded and involved an impermissible assumption that there were no litigable issues or claims in the action.

The court's reasoning assumed that there was no merit to plaintiffs' claims and thus involved an improper prejudgment

* Appellants are aware of recent authorities indicating that perhaps the same person cannot serve as both plaintiff-class representative and class attorney. See, e.g., Turoff v. The May Co., F.2d (6th Cir. 1976), 21 F.R. Serv. 2d 503. Cf., Kramer v. Scientific Control Corp., F.2d (3d Cir. 1976), 21 F.R. Serv. 2d 1223, 1231 (Rosenn, C.J., concurring). That issue appears to be one of first impression in this circuit.

**Appellants' position in this connection is set forth in their brief dated 3-7-77, at p.224.

or consideration of the merits of the action.*

4. Special circumstances with respect to the qualifications of Roy Brewer to act as class representative.

Appellants' position in this connection is set forth in their brief dated 3-7-77, at p. 229. Limits of space preclude its inclusion here.

POINT VIII

IT WAS REVERSIBLE ERROR FOR THE COURT BELOW TO DISMISS THE DIRECT AND DERIVATIVE CLAIMS AGAINST THE DASA OFFICERS AND DIRECTORS UNDER RULE 41(b).

The district court dismissed the action as against certain DASA officers and directors under Rule 41(b), F.R. Civ. P., citing, Joseph Muller Corp. v. Societe Anonyme de Gerance, 508 F.2d 814 (2d Cir. 1974), in a series of rulings

* Swanson v. American Consumer Indus., Inc., 425 F.2d 1326 (7th Cir. 1969); 475 F.2d 516 (7th Cir., 1973). It was the district court's obligation at that stage of the litigation to assume the truth of the allegations of the complaint. It erroneously failed to do so. Esplin v. Hirschi, 402 F.2d 94, 99-101 (10th Cir. 1968), cert. denied, 394 U.S. 928 (1969) (The interests of justice require that any error, if there was to be one, should be committed in favor of allowing the class action.) The only way there could have been "no class" for plaintiffs to represent was if there were no common issues or claims in the action. If there were any such issues or claims (as in fact there were until at least mid-trial in June 1975), then each such issue and claim was common to the bondholder class and should have been litigated on a class action basis if the elements of Rule 23 were satisfied. It is clear that the court erroneously assumed that there were no litigable issues.

Since one form of relief sought was money damages which plaintiffs sought to prove at trial were \$367 per bond, there is good reason to doubt that many (if any) of the class members would have "opted out" of the action if they had received a proper Rule 23 notice. Moreover, failure to withdraw earlier consents did not in any way indicate a waiver of any claims for breach of fiduciary duty on the conversion price issue. All those consents indicated was a willingness to let the computer sale go through, if that,

beginning with a handwritten endorsement (dated 5-6-75) on the back of motion papers filed by counsel for DASA on behalf of defendant Greeff. The defendants thus dismissed were: Greeff (director, RD 99), Le Buhn (director, RD 103), Stern (director, RD 107), Bolivar (director, financial vice president, RD 109), Reichter (director, president, RD 110).

DASA had cited Joseph Muller for the proposition that "undue delay in service of a summons and complaint on a defendant after the commencement of an action without adequate justification is a ground for dismissal under Rule 41(b) for failure to prosecute. Prejudice to the defendant need not be shown." (Memo, pp. 1-2, RD 100). In that case, the Second Circuit stated that "an unexplained and unreasonable delay in service constituted grounds for dismissal, without regard to any showing of actual prejudice." Thus the five defendants conceded in their motion papers that the service of late process on them in fact caused no "actual prejudice" to any of them.

1. The failure to serve process on the five director defendants at an early stage of the action was neither unexplained nor unjustified in the circumstances.

The "derivative allegations" in the complaint are set forth in paragraphs (9)-(16) (pp.23-24).

Essentially, the derivative action theory was that it was corporate waste and a breach of fiduciary duties for DASA's management to engage in a proxy solicitation of questionable validity under the proxy rules and in

extensive litigation over the legitimacy of the solicitation when the question of proxy rule violation and the necessity for expensive litigation on charges of conflict of interest could be avoided by DASA simply doing what the fiduciary duties of its directors required in any event: hire an unbiased expert to suggest a fair conversion price or select a price acceptable to Browning, who was himself a financial expert. Total fees paid to DASA's counsel during the pendency of this action prior to 11-22-76 amounted to more than \$350,000 of which at least \$100,000 was attributed to defense of the action in DASA's fee applications below. Undoubtedly, there were many other expenses that could have been avoided if DASA had either complied with its legal obligations to the bondholders or cooperated with plaintiffs in obtaining a prompt adjudication on appeal as to what those obligations were. Instead, DASA's management has made the judicial determination as long and as complex a process as possible, apparently in the hope that plaintiffs could be ground into capitulation by the depletion of their funds and emotional resources in a legal war of attrition.

The "direct" claims were for breach of fiduciary duty and violation of §14(a).

Clearly there was no point in serving process on the individual defendants until the initial procedural skirmishes, including determination of the class action motion had been completed. If that motion should be denied,

it might require a decision to discontinue the action. If it should be granted, the action might be promptly settled without drawing the individual defendants into the action unnecessarily. The Rule 23 motion was filed on 5-19-72. Plaintiffs' related memorandum of law was filed on 6-5-72. The motion was not decided until 7-16-74 (RD 63). Plaintiffs were justified in withholding service on the individual defendants until that time. And there had clearly been no failure to prosecute other aspects of the action, including document discovery, interrogatories, requests to admit, application for a temporary injunction, and a motion for summary judgment on Claims 1 and 2.

In order to decide whether or not to expend limited financial resources serving the individual defendants, plaintiffs' attorney thought it necessary to have the benefits of rulings on the merits of Claims 1 and 2. Discovery efforts were conducted by all available devices except depositions until approximately February of 1973. *

* On 2-26-73, plaintiffs moved for summary judgment on Claims 1 and 2. Judge Griesa denied that motion on 10-1-73 (RD 56). An appeal was taken from that dismissal promptly after an appealable judgment was entered on 10-15-74. That appeal was not argued until 9-3-75, and not decided until 10-3-75.

During 1973 and after other discovery was completed, it was decided that the funds available to plaintiffs for prosecution of the action would not permit discovery by the usual method of using court stenographers who charge approximately \$2.00 per page for transcripts at ordinary rates. Consequently, plaintiffs moved on 8-23-74 under Rule 30(b) for permission to conduct depositions by other than stenographic means. That motion was denied on 10-9-74, and plaintiffs included an appeal from that order as part of the appeal on Claims 1 and 2. That aspect of the appeal was dismissed without decision on 10-3-75.

One justification for plaintiffs' failure to serve process on the individual defendants is that their attorney wanted the benefit of some depositions before deciding whether or not they should be served, and he never got the benefit of such discovery because the district court erroneously refused to allow depositions by a method the plaintiffs could afford. In fact, plaintiffs have still not had the benefits of any depositions because their right to tape recorded depositions is one of the issues on this appeal. Moreover, plaintiffs did not have an appellate determination on the dismissal of Claims 1 and 2 until three months after process had been served on the individual defendants and the action dismissed as against them for "failure to prosecute" the action.

2. Plaintiffs had not been inactive in prosecuting the action between its commencement in 1972 and the dismissal as to the individual defendants in May of 1975.

The truth of the above statement is clear from the previous discussion and from the record in the action. Moreover, if the action must be remanded for trial against Anderson and the bank, or either of them, and against DASA on the issue of damages, there will be no prejudice to the individual defendants if the action against them is tried at the same time.

3. This was not a proper occasion for the dismissal of an action with prejudice against the responsible corporate officials.

In the Second Circuit, dismissal with prejudice is considered "a harsh remedy to be utilized only in extreme

situations." Thielman v. Rutland Hospital, Inc., 455 F.2d 853, 855 (2d Cir. 1972) (Reversal denied where plaintiffs' counsel failed to prepare the case for trial on a date set by the court but instead went on vacation, sending a letter to that effect to the court, and later showed no inclination to prepare the action promptly for trial.)

Where the action has been vigorously prosecuted, an explanation has been made for failure to serve some of the defendants, and further trial proceedings will be required after appeal in any event, a plaintiff should be allowed his day in court against all defendants, especially where no significant prejudice to the defense has been indicated. Vindigni v. Meyer, 441 F.2d 376 (2d Cir. 1971) (Dismissal under Rule 41(b) reversed.); Zitmer v. Holdsworth, 449 F.2d 724 (3d Cir. 1971) (Dismissal affirmed where absolutely no effort was made to prosecute the action over a period of nine years.)*

* This is not a case in which plaintiffs have failed to appear or respond to a motion to dismiss the action [Southeastern Compress & Warehouse Co. v. Page, 3 F.R. Serv. 41b. 11, Case 2 (N.D. Ga. 1940)], or failed without explanation to appear at a pretrial hearing [Zaroff v. Holmes, 379 F.2d 875 (D.C. Cir. 1967); Link v. Wabash R.R., 370 U.S. 626 (1962)], or stated on the day set for trial that plaintiffs have no desire to proceed with the suit [Lynch v. Nat. Bondholders Corp., 2 F.R.D. 376 (E.D. Mich. 1972)], or in which the overall context of the action and its history justifies dismissal against the defendants who made for reasons of financial self-interest the corporate decisions that violated the plaintiffs' rights and caused them great financial harm [Edmond v. Moore-McCormick Lines, 253 F.2d 143 (2d Cir. 1958); Walsh Bros. v. Automatic Poultry Feeder Co., 439 F.2d 95 (8th Cir. 1971)], or in which the plaintiffs have failed to bring the action to trial after being ordered by the court to do so [Theodoropolous v. Thompson-Starrett Co., 49 F.2d 350 (2d Cir. 1969); West v. Gilbert, 361 F.2d 314 (2d Cir. 1966)].

POINT IX

IT WAS ERROR TO DENY PLAINTIFFS' APPLICATION UNDER RULE 56(d) OR RULE 16 AND THE HOLDING OF NATIONAL LIFE INS. v. SILVERMAN, 454 F.2d 879 (D.C. CIR. 1971), FOR AN ORDER LIMITING THE ISSUES FOR DISCOVERY AND TRIAL BY DETERMINING UNDISPUTED FACTS.

Appellant's position on this point is set forth at page 240 of their brief dated 3-7-77.

POINT X

THE DISTRICT COURT SHOULD HAVE GRANTED PLAINTIFFS' TRIAL MOTION THAT THE COMPLAINT BE DEEMED AMENDED TO CONFORM TO THE PROOF. ON REMAND THE COMPLAINT SHOULD BE FORMALLY AMENDED OR DEEMED AMENDED AS REQUESTED IN PLAINTIFFS' POST-TRIAL MOTION.

During the trial, plaintiffs' counsel moved or suggested to the court that the amended complaint be deemed amended to conform to the proof presented in support of plaintiffs' case. In order to make clear on the record that such a motion had been made, plaintiffs' counsel sent a letter to the court on June 10, 1975 promptly after the close of the trial, stating:

"[W]e would like for the record to note at the close of plaintiffs' case and in connection with post-trial motions by both sides a motion by the plaintiffs that their pleadings be amended to conform to the proof presented during the trial."

For the purpose of further clarifying the record and stating specifically the respects in which plaintiffs wished their pleadings to be deemed amended, they filed on July 29, 1975, a formal motion (RD 113) for an order pursuant to Rule 15(b), F.R. Civ. P., granting them leave to amend their pleadings to conform to the trial proof and deeming the complaint amended by adding thereto 20 subdivisions to paragraph (22) of the complaint and a new paragraph (22A) containing two subparagraphs. In support of that motion they filed their proposed findings of fact and conclusions of law (previously submitted to the court on 6-20-75) and a memorandum of law in which they quoted the text of Rule 15(b) and relevant portions of text from 6 Wright & Miller, Federal Practice and Procedure §1471 (at 359-360), pointing out "the emphasis Rule 15 places on the permissive approach that the district courts are to take to amendment requests, no matter what their character may be. . . ."

In a handwritten endorsement on the face of plaintiffs' motion papers dated the day of filing thereof (7-29-75), the district court denied the motion in the following words:

"Memorandum - Plaintiffs move after a six day trial to amend their pleadings to conform to trial proof. Unlimited opportunity existed before the trial to move to amend of which plaintiffs were fully aware, having so moved in other respects. Proof on the trial was specifically limited by the Court to the issues raised by Claim 3 of the complaint and the answer of DASA thereto. There was no express or implied consent to any other issues. The motion is therefore denied."

Appellants submit that in so ruling the district

court committed reversible error, Their reasons are set forth in their brief dated 3-7-77 at pages 243-249. In support of their argument, they rely upon the following authorities, among others there cited: 6 Wright & Miller, Federal Practice & Procedure §§ 1471, 1491, 1493, 1495; 3 Moore's Federal Practice §§ 15.02[1], 15.13[2], 15.14; Foman v. Davis, 371 U.S. 178, 182 (1962); Civil Rules 1, 8(a)(2), 8(f) and 15; Conley v. Gibson, 355 U.S. 41 (1957); U.S. v. Employing Plasterers' Assoc., 347 U.S. 186, 189 (1954); Bradford Audio Corp. v. Pious, 392 F.2d 67, 73-74 (2d Cir. 1968).

POINT XI

THE DISTRICT COURT'S DECISION TO ENTER JUDGMENT AGAINST PLAINTIFFS AND THEIR ATTORNEY ON GROUNDS OF MALICIOUS PROSECUTION WAS (A) NOT WITHIN THE SUBJECT MATTER JURISDICTION OF THE COURT, (B) WITHOUT FACTUAL OR LEGAL BASIS, (C) IN VIOLATION OF APPELLANTS' CONSTITUTIONAL RIGHTS, (D) BASED UPON AN UNCONSTITUTIONALLY BROAD AND VAGUE INTERPRETATION OF THE TERMS "BAD FAITH", "FRIVOLOUS" AND "VEXATIOUS," (E) CONTRARY TO FEDERAL PUBLIC POLICY AS EXPRESSED IN THE SECURITIES LAWS, (F) IN DEROGATION OF PLAINTIFFS' RIGHT TO APPEAL, (G) AN ABUSE OF DISCRETION, (H) NOT SUPPORTED BY APPROPRIATE FEE APPLICATIONS, AND (I) ERRONEOUS.

1. The defendants' fee applications were made and granted upon grounds of malicious prosecution. As a matter of law under the Federal Rules, such a claim does not mature for jurisdictional purposes until the original claim has been finally determined in favor of the defendant.

The defendants' fee applications below were made

and granted upon grounds of malicious prosecution. DASA's was the main application. In its memorandum in support of its application (p. 6), DASA stated unmistakably that its motion was based "upon the theory that the entire lawsuit was improperly commenced and prosecuted." That was a clear description of a malicious prosecution claim. Even if the movants had not so labeled their claims, the recovery sought is, as a matter of law, in the nature of a malicious prosecution claim.

The district court lacked subject matter jurisdiction over defendants' claims for attorneys' fees because, as a matter of law, they had not matured and were not ripe for adjudication. Therefore, it was jurisdictional error when the district court denied appellants' motion to dismiss on those grounds.

It has been well-established law under the Federal Rules of Civil Procedure since 1940 and repeatedly restated over the thirty-five years that have passed since then that a claim by a defendant for damages based upon the bringing of the main action or upon proceedings taken in the course of the main action is in the nature of a claim for malicious prosecution, and such a claim does not mature and cannot be pleaded or recovered upon under the Federal Rules until the main action has terminated or been finally

determined.*

2. The holding below of malicious or "bad faith" prosecution was completely unfounded in fact or law.

A claim for malicious prosecution against an attorney is dependent upon the existence of three elements: the prior civil action must have terminated in...[the claimant's] favor; respondent must have lacked probable cause in representing.... [his] client; and respondent must have acted maliciously." Tool Research & Engineering Corp. v. Henigson, 46 Cal. App. 3d 675, 682-683; 120 Cal. Rep. 291 (2d App. Dist. Div. 1, 1975).

In an affidavit filed below, plaintiffs' attorney, Bradley R. Brewer, described the "probable cause" for commencement and prosecution of this action, i. e., his honest belief that his clients had a tenable and meritori-

* Goodyear Tire & Rubber Co. v. Marbo Corp., 32 F.Supp. 279 (D. Del. 1940) ("Pleading a claim for damages arising from the wrongful bringing of an action before the final determination thereof is premature and unauthorized by the Rules of Civil Procedure."); Slaff v. Slaff, 151 F.Supp. 124, 125 (S.D.N.Y., 1957, Bryan, J.); Schwab v. Doelz, 229 F.2d 749, 753 (7th Cir. 1956); Rosemont Enterprises, Inc. v. Random House, Inc., 261 F.Supp. 691 (S.D.N.Y., 1966, Weinfeld, J.); 3 Moore, Federal Practice (1974 ed) ¶ 13.32, ¶ 13.13. See brief dated 3-7-77, pp. 251-257 for additional authorities and a discussion of the utter factual irrelevance of the authorities cited below by Judge Owen.

ous claim, and the reasonable basis for that belief.*

There is absolutely nothing in the record contrary to those statements and demonstrations of probable cause. It was completely erroneous for the district court to base a finding of bad faith and malicious purpose upon the number of entries in the docket sheet.

In this action Claims 1 and 2 were conceded to be the weakest part of plaintiffs' case, but when plaintiffs appealed the dismissal of those claims and DASA moved for a finding of frivolousness and double attorneys' fees in connection with its motion to dismiss the appeal, DASA's motion was denied. This Court thus concluded that those claims were not frivolous in a decision that was not rendered until 10-3-75, nearly four months after the trial on Claim 3 before Judge Owen.

No fees could properly be awarded below for services rendered prior to 10-3-75 (when the Claim 1 and 2 appeal was decided) because until that time plaintiffs' counsel clearly had pending in the action claims this Court has held with

* (See, aff. of BRB dated 2-19-76 in support of motion to reargue, RD 127. See also, memo dated 7-14-75 in opposition to DASA's motion for fees, mailed to chambers on 7-17-75, RD ; aff. of BRB dated 8-21-75 in opposition to the bank's fee application, RD ; aff. of BRB dated 1-20-76 in opposition to DASA's motion and affidavits of services, RD 116; memo of REB dated 3-1-76 in support of motion to reargue, RD 128.

finality to be nonfrivolous.*

3. The award of attorneys' fees below was in violation of appellants' constitutional rights.

- (a) Violation of the "Principle of Free Advocacy" under the First and Fifth Amendments.

The award below of attorneys' fees was not based upon the presentation of any false or perjured testimony, nor had plaintiffs' attorney made any false statements or arguments to the district court. Moreover, there

* The pendency of a tenable appeal, which he believed to have a chance of prevailing, imposed upon plaintiffs' counsel a professional obligation to prosecute the remainder of the case through trial on Claim 3. If he had voluntarily dismissed Claims 3, 4 and 5 and then prevailed on Claims 1 and 2 several months later, he could have been charged with failing in his ethical obligation to prosecute vigorously claims he reasonably believed to be arguable and worthy of succeeding. Canon 7 of the American Bar Association Code of Professional Responsibility states that "a lawyer should represent a client zealously within the bounds of the law." Plaintiffs' counsel below did no more than that. To have done less would have been inconsistent with his professional obligation to his clients. EC 7-1 states that "in our government of laws and not of men, each member of our society is entitled . . . to seek any lawful objective through legally permissible means; and to present for adjudication any lawful claim, issue or defense." The actions in this suit of plaintiffs and their counsel were well within the bounds of that ethical consideration. EC 7-3 states that "while serving as an advocate, a lawyer should resolve in favor of his client doubts as to the bounds of the law." EC 7-4 provides, with respect to the duty of a lawyer to his client, that "the advocate may urge any permissible construction of the law favorable to his client, without regard to his professional opinion as to what he believes would likely to the ultimate decision of the courts on the matter at hand" Here counsel was well within the bounds of proper ethical advocacy because he believed not only that plaintiffs' position was reasonably arguable, but that it was meritorious as a matter of equity. On that subject, his sworn statement in the record stand un rebutted.

was not present below any evidence that plaintiffs or their counsel knew their claims to be lacking in merit as a matter of fact or law, as the law requires for a finding of "bad faith" or "malicious" prosecution of a civil action.*

In this case, the finding below of "bad faith" prosecution of "frivolous" claims was based purely upon the district court's disagreement with arguments presented by plaintiff's attorney on questions of law and mixed questions of law and fact. In effect, the district court's punitive imposition of defendants' counsel fees constituted a form of punishment for the presentation as a matter of advocacy of arguments which the court found philosophically or doctrinally unacceptable. Among other things, it was simply inconceivable to Judge Owen that a fiduciary relation might be found to exist between DASA's management and the bondholders on the facts of this case. The district

* See, Alland v. Consumers Credit Corp., 476 F.2d 951 (2d Cir. 1973), where the president of the defendant finance company told plaintiffs' attorney (BRB) that he had been told by counsel for the finance company that he had no defense to enforcement of the notes sued upon, and the defendant proceeded to hire different counsel and present an admittedly specious defense merely to delay making payment; Buckhalter v. Rude, 54 F.2d 834 (10th Cir. 1931), aff'd, 286 U.S. 451 (1932), where the defendants were advised by their lawyers that "nothing could be gained" by the fictitious transaction they contrived as a defense, and they went through with it and used it as a defense anyway, knowing that it was specious. There were no facts of that kind in this case, and for lack of them the legal requirements for a finding of "bad faith" were not present here.

court's view of the bondholders' limited rights under the indenture was rooted squarely and plainly in precisely the kind of laissez-faire philosophy that the federal securities laws were enacted to replace through the exercise of a more informed conscience by federal judges acting as courts of equity.

Punishment of counsel for presenting tenable legal arguments which he was ethically obligated to make constitutes a violation of First and Fifth Amendment rights which the Supreme Court has referred to collectively as "the principle of free advocacy." F.D. Rich Co. v. Industrial Lumber Co., 417 U.S. 116, 129 (1974). *

Appellants maintain that "the principle of free advocacy" cited in Rich is a bundle of constitutional rights derived from the First Amendment right to freedom of speech, the Fifth Amendment right to due process of law, and the First Amendment right to petition the federal courts for redress of grievances. They contend that the fee award below constituted an impermissible penalty on the exercise of those constitutionally protected prerogatives by the

* There the Court underscored the policy difference between (a) awarding attorneys' fees against a defendant who has presented a defense which he knew to the point of certainty was specious and (b) awarding fees against a plaintiff who has attempted to present a claim for adjudication in a federal court. For example, a defendant, unlike a plaintiff, is not attempting to make a constitutionally protected petition for redress of grievances to a federal judicial agency. California Motor Transport Co. v. Trucking Unlimited, 404 U.S. 508, 510 (1972); Eastern Railroad Presidents Conference v. Noerr Motor Freight, Inc., 365 U.S. 127 (1961); United Mine Workers v. Pennington, 381 U.S. 657 (1965).

plaintiffs. Moreover, those awards also penalized impermissibly the performance by plaintiffs' counsel of his professional obligation to advocate his clients' cause vigorously through the use of all reasonable arguments. The judicial policy behind the "principle of free advocacy" has the same root as the well-recognized rule that an attorney is privileged and immune from suit for libel and slander based upon statements made in legal proceedings (35 N.Y. Jur., LIBEL and SLANDER § 138). If an attorney is so protected by the law in his role as advocate that he may commit conscious slander without being held liable for damages, he surely must be even more zealously protected when he makes arguments on the law which he believes to be not merely arguable but entitled to prevail.

(b) Violation of the Right to Petition for Redress of Grievances under the Noerr-Pennington Doctrine.*

(c) Violation of the Void-For-Vagueness Doctrine by Applying the Terms "Bad Faith," "Frivolous" and "Vexatious" in an Unreasonably Broad and Vague Manner in Derogation of Plaintiffs' First Amendment Rights.

Related to the above arguments is appellants' contention that the court below violated their rights to

* REB adopts all of the arguments put forth in the brief submitted by SCB, except Point V, to which both REB and BRB object, for the reasons set forth below in RD 170 and 171. BRB adopts Points II through IV of SCB's Brief, Point III makes the Noerr-Pennington argument.

due process of law by applying the terms "bad faith," "frivolous" and "vexatious" in such a broad and vague manner as to violate the "void for vagueness" doctrine in the context of appellants' exercise of First Amendment rights in presenting their arguments below. See, Giaccio v. Pennsylvania, 382 U.S. 399 (1966).*

(d) Violation of Due Process in the
Exclusion of Evidence Favorable
to Plaintiffs on the Issue of
Their Good Faith in Prosecuting
the Action.

DASA's proceeding for fees was commenced at the close of the trial of the main action without affording appellants reasonable notice and opportunity to be heard. During the trial, plaintiffs' counsel tried unsuccessfully a number of times during the direct testimony of SCB and REB to present evidence as to their reasons and purposes for bringing the action as evidence relevant to the merits of the action and to the existence of "good faith" on their part. After SCB and REB testified, each left the trial, SCB to return to his business and REB to return to urgent business matters at his home in Omaha, Nebraska.

The court rigidly excluded such testimony by SCB and REB on the ground that "I'm not interested in any

* See also, Connally v. General Construction Co., 269 U.S. 389 (1926), Lanzetta v. New Jersey, 306 U.S. 451 (1959); Amsterdam, "The Void-For-Vagueness Doctrine in the Supreme Court," 109 U.Pa.L.Rev. 67 (1960); Zwickler v. Koota, 389 U.S. 241, 249-50 (1967); Cameron v. Johnson, 390 U.S. 611 (1968); Keyishian v. Board of Regents, 385 U.S. 589 (1967).

way, shape or form in what Mr. Browning's state of mind was in February of 1972," when this suit was begun by him. *RD 130
(T-SCB-64)* On cross-examination of Browning, however, the subject of his purposes and motives suddenly struck the court as matters of utmost relevance. "Mr. Bayda: Excuse me, but I would like to point out that the cross-examination [of SCB] was directed to the purposes and motivations of the Browning Committee. The Court: I understand that." *RD 130
(T-SCB-217)* On redirect, the subject of Browning's motives again became irrelevant.

In short, DASA was permitted to elicit testimony to support its allegations of "bad faith," but plaintiffs were not permitted to introduce testimony as to their "good faith." This made the trial on good faith fundamentally unfair and violated appellants' due process rights.

Applications that SCB, REB and BRB be permitted to give post-trial testimony at the "Grinnell" hearing to determine the amount of the fee award were denied in the opinion of 7-23-76. (Op. #44, 824; RD 135).

Among other things, BRB had no notice when the fee application was made by DASA that a counterclaim was being filed against him on the theory that he was a "plaintiff," although he was not named in the complaint. Consequently, he was deprived of a due process opportunity to present testimonial evidence in his own behalf on the issue of his good faith and "probable cause" for commencing and prosecuting the action.

4. The decision below fixing the amount of the fee award was (a) arbitrary on its face, (b) based upon no reasoning or analysis at all of the evidence presented, and (c) defective by virtue of the district court's failure to require of the defendants the kind of specific proof that is necessary in this circuit to support an application for attorneys' fees.
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(a) The Decision Below.*

The \$40,000 Award to DASA

A fee of \$40,000 was awarded to the attorneys for DASA exclusively for the following categories of services:

- (a) "pretrial motion work"; (b) "pretrial preparation"; (c) "the trial itself"; and (d) "the preparation of proposed findings and conclusions."

What "pretrial motion work" Judge Owen had in mind is impossible to determine. In its fee application affidavit (Kappus, 1-15-76), JPP listed the following items that

* The decision fixing the amount of the fee award below (RD 153, filed 1-4-77) was based upon documentary evidence and testimony presented on behalf of the three moving defendants, upon written submissions by the appellants, and upon cross-examination by appellants' counsel of defendants' witness at a hearing held on 11-22-76.

In that opinion (p.1), Judge Owen adopted all of the reasons and conclusions set forth in his opinion filed 1-12-76 (RD 115A). In direct conflict with many of his earlier conclusions (which had found the complaint and every paper filed and action taken by plaintiffs' counsel in the district court and this Court to have been "frivolous" and in "bad faith"), he limited the stated basis for the fee amounts set forth to "services performed in connection with matters that were before the District Court and particularly those where I personally observed the conduct giving rise to the propriety of any award." The opinion then fails completely to specify the "conduct" which Judge Owen supposedly "observed" and upon which the fee awards were based. Putting the 1-12-76 and 1-4-77 opinions together, the court's reasoning is hopelessly vague.

might fall within that category and requested an "average hourly rate" for the hours spent of \$57.65:

<u>Work Item</u>	<u>Hours</u>	<u>Amount- Requested</u>
Opposing motion for partial summary judgment as to Claims 3 & 4	22.8	\$ 1,314.42
Preparation for trial	314.9	18,153.99
Trial and legal research during trial	97.7	5,632.41
Preparation of proposed findings and conclusions and a post-trial memorandum	57.3	3,303.35
Miscellaneous (totally unexplained and undocumented)	126.1	7,269.67
Total (including "miscellaneous")	618.8	\$35,673.82
Total (excluding "miscellaneous")	492.7	\$28,404.16

From the above figures, it is readily apparent that, based upon his own opinion and the relevant affidavit, Judge Owen awarded DASA more in fees than it applied for with respect to the services covered by the opinion.* Awarding fees for completely unspecified, unexplained, and unjustified services called "miscellaneous" would ob-

* What Judge Owen did, in fact, was simply to pick the figure of \$40,000 out of the air, without even bothering to square his conclusion with the relevant affidavit submitted by DASA's counsel. If he had paid any attention at all to the papers before him, he could not possibly have selected the figure he did for the services he indicated. That is one reason why the fee award to DASA was patently arbitrary and why it must be reversed. See RD 150, 168, ¶20-23, pp. 14-19.

viously constitute an error or abuse of discretion absent a rational explanation by the court that is completely lacking here. Even including "miscellaneous," Judge Owen gave DASA an unrequested "bonus" of \$4,326.18, without explaining why he did it, and perhaps without even knowing he had done it. If "miscellaneous" is excluded, as it should be, then the unrequested "bonus" to DASA was \$11,595.84.

The "average hourly rate" of \$57.65 requested by JPP for DASA was based upon a "fee schedule" for the firm attributing to its attorneys during stated periods of time "hourly rates" ranging from \$25 to \$135. (Kappus aff. of 2-6-76, p. 2). *

Appellants submit that it was reversible error and an abuse of discretion for Judge Owen to exclude from the record facts necessary to determine how many hours were charged by DASA at more than \$60 per hour. (See RD 171,

* Appellants' counsel demanded that JPP break down each of its stated "items of work" into the attorneys who put in the hours charged and the rates charged for the hours, so that there would be some basis in the record for determining how the \$57.65 "average" was arrived at and how many hours were charged above that rate. Appellants were particularly concerned to know how many \$135 hours were being sought for the services of Marshall Jacobs and Richard Persinger, because the JPP diary sheets submitted to the court showed both of them charging for time spent in court during the trial of this action waiting to give testimony and testifying, and during that time both men simply sat in the courtroom and did nothing to act as attorneys in the case. They were witnesses and nothing more. But their time was charged by DASA in its application as "trial services."

JPP had available at the 11-22-76 hearing the information necessary to provide the additional information requested by appellants' counsel. On cross-examination, Mr. Kappus of JPP provided additional information explaining 178.8 hours attributed in his affidavit of 1-15-76 to "opposition to plaintiffs' motion for a preliminary injunction."

pp. 8-10).

It was further arbitrary and contrary to controlling principles of law set forth in City of Detroit v. Grinnell Corp., 495 F.2d 448 (2d Cir. 1974), for Judge Owen to award \$40,000 to DASA and \$7,000 each to Andersen and the bank without determining in the case of any of the three applicants either (a) the number of attorney hours credited to the attorneys or (b) the hourly rate to be attributed to those hours.

The \$7,000 Awards to Andersen and the Bank

DASA and Andersen both filed fee schedules which apparently were used by the respective attorneys in billing their clients. However, Judge Owen would not allow cross-examination to determine (a) how the bills were computed, (b) what relationship (if any) there was between bills submitted, fees paid, and the fee applications submitted to the court, (c) which of the hours listed in the fee applications were given the different hourly rates set forth in the fee schedules filed, or (d) what contribution to advancement of the case was made by any of the hours or services listed. Appellants' counsel was permitted access to the JPP fee schedule in briefing this appeal, but, by order of Judge Owen on motion by Andersen, the fee schedule of Breed, Abbott ("BAM") was sealed and therefore unavail-

able in preparing this brief.*

The bank did not make any attempt at all to submit the kind of specific documentation for its fee application that is required in this circuit under prior decisions of this Court. And Judge Owen did not have before him sufficient information to make the kind of reasoned and factually justified fee determination the law requires with respect to the bank's application. Unfortunately, his opinion of 1-4-77 (RD 157) makes perfectly clear (and the 11-22-76 hearing record will confirm) that Judge Owen was not concerned in the slightest about having such facts available in the record, and when they were available (to some extent) he simply ignored them completely and picked the arbitrary numbers of \$40,000, \$7,000 and \$7,000 right out of his head---without bothering with even the pretense of a supporting calculation to give some semblance of reason to the decisions he made.

* S&C did not file a fee schedule or any comprehensible breakdown of its services and the hours of work put forth on the case from which one might assess the necessity for or utility of the services covered by the application. In fact, Edward Keane, the S&C partner who testified on 11-22-76, stated that his firm did not have any hourly fee schedules, and the amounts of the bills sent by S&C to the bank in this case were not based upon any analysis of the time spent by attorneys or the work they did but rather were picked by Keane out of thin air or his own head as amounts that S&C might be able to charge the client in the circumstances and the client might be expected to pay. Having picked a nice fat number, he called the bank and asked if they would accept a bill for that amount, and it said yes.

Of course both Keane and the bank knew that DASA and not the bank would be paying the bill, so one might reasonably wonder whether either of them cared very much about whether the amount charged was too large or too small.

The bank's fee application disclosed that S&C had concluded and advised the bank on 11-10-72 (during the 1st year of this case) that the claim against the bank was "without merit." The dispositive issue was clearly one of pure law which could easily and simply have been made the subject of a motion to dismiss at that time under Rule 12(b) or Rule 56 if the bank was truly confident about its conclusion. By its own admission, all S&C did from that point until 1975 (when plaintiffs moved for summary judgment as to liability against the bank) was to watch the progress of the action from the sidelines and make repeated motions for an undertaking to secure an eventual award of their counsel fees, which were finally granted on the eve of trial so that the bank would not be involved in the trial. *

Similarly, the claims against Andersen were dismissed on technical points of procedural law (no allegation of direct proxy solicitation by Andersen; no allegation of derivative action demand for suit; Zirin aff. of 1-21-76, ¶8) on 4-21-75. Andersen's motion to dismiss could have been

* Appellants contend (a) that the bank's failure to make a dismissal motion indicates that they were not sufficiently confident or their case on the merits to risk losing such a motion and (b) that if a reasonable basis for such a motion existed that early in the action, then plaintiffs should not be required to pay dearly for the bank's failure to make it, and the bank should not be allowed fees for any services after December of 1972 (at the latest), when the bank's dismissal motion could have, and should have, been made.

The crucial question with respect to the bank's claim for fees is this: If Claim 4 was in fact "clearly frivolous" and Sullivan & Cromwell knew it to be so quite early in the case, then why did they not make a motion to dismiss that claim at the earliest possible time?

as easily made in 1972 as 1976, and plaintiffs should not be required to pay the cost of pursely "pro forma" services rendered by BAM in the interim. (See RD 150, 168, ¶26, pp. 22-23).

- (b) Refusal of the district court to require disclosure, at the hearing on 11-22-76, of the nature and operation of the "fee arrangement" between DASA and the bank pursuant to which DASA paid all of the bank's fees in this action.

It is basic law in this circuit that when a party applies for an award of attorneys' fees, the nature of the "fee arrangement" between attorney and client must be openly disclosed in court. Grinnell, supra, 495 F.2d at 473.

Here the operative "fee arrangements" were more complex, because DASA was paying the bank's fees even though the thrust of the action against the bank was that it had stood idly by, quite willfully, in violation of its duties as a trustee and fiduciary, and permitted DASA's directors to perform an unconscionable equitable fraud upon the bondholders without even bothering to alert the bondholders about what was being done to them.

Appellants demanded full disclosure at the hearing on 11-22-76 of the relevant "fee arrangement" among DASA, the bank, and their firms of attorneys, citing Grinnell. Judge Owen erroneously excluded that evidence from the record.

5. In making the fee awards, Judge Owen erroneously failed and refused to take into consideration appellants' ability to pay, something he was required by law to do.

In their memorandum filed below on 11-24-76 (RD 150), appellants presented circumstances to the district court concerning their financial circumstances in support of their request that the judgment entered against them not exceed the total sum of \$5,000.*

In Grinnell, supra, 495 F. 2d at 467, this Court held that "defendants ability to pay" must be a substantial factor in determining the amount of an award of attorneys' fees. In awarding judgment below for a total of \$54,000, Judge Owen erroneously gave no consideration at all to the financial condition of either attorney Bradley Brewer or plaintiff Roy E. Brewer.

The district court and appellees are well aware of those critical circumstances. Indeed, there is reason to suspect that the intended effect of seeking a prohibitive fee judgment from the district court was to force appellants to give up this litigation by making its costs too rich for their blood and making it impossible for them to obtain appellate adjudication of their case on its merits.

In a very real sense, one of the central issues in this case is whether plaintiffs of ordinary means, neither

* See brief dated 3-7-77, p. 285.

paupers nor giant corporations, can effectively prosecute an action under the securities laws in the face of a well-financed defense presented by three large, "Wall-Street" law firms.

6. Where the statute involved does not expressly provide for an award of attorneys' fees to a successful litigant, such an award cannot be made.

The foregoing proposition is squarely supported by Fleischmann Corp. v. Maier Brewing Co., 386 U.S. 714 (1967) (Lanham Act), and Alyeska Pipeline Service Co. v. Wilderness Society, 421 U.S. 240 (1975). In this case, the Exchange Act does not authorize an award of fees to either DASA or Andersen. Unlike § 11(e) of the Securities Act, the Exchange Act does not authorize either the requirement of security for costs or the award of fees to a victorious defendant. Consequently, orders authorized by § 11(e) are not permitted in suits under the Exchange Act. Borak v. J. I. Case Co., 317 F.2d 838 (7th Cir. 1963), aff'd on other grounds, 377 U.S. 426 (1964). See also, Eagle v. Horvath, 241 F. Supp. 341, 345 (S.D.N.Y. 1965); Phelps v. Burnham, 327 F.2d 812, 814 (2d Cir. 1964) (state security statute inapplicable to federal claim).

7. In the absence of "unwarranted personal conduct" by a litigant or his attorney, a punitive award of attorneys' fees is not justified.

See appellants' brief dated 3-7-77 for this argument. Authorities cited include: Incarcerated Men of Allen County

Jail v. Fair, 507 F.2d 281, 284 (6th Cir. 1974); Adams v. Carlson, 521 F.2d 168, 170 (1975); In re Sutter, F.2d (2d Cir., 10-20-76, Docket No. 76-1194).

CONCLUSION

For the reasons set forth above, each of the judgments and orders appealed from should be reversed and the action remanded for appropriate action consistent with this Court's opinion by a district judge other than Judge Owen.

Appellants respectfully submit that as to DASA, the bank, and Andersen, this court should assess liability for the violations of law alleged and proven on the present record and remand the action for trial of the issue of damages only. As to the individual defendant officers of DASA, the dismissals should be reversed and the action remanded for trial as to both liability and damages.

Dated: New York, N.Y.
March 22, 1977

Respectfully submitted,

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